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DEFINITION OF INSIDER TRADING

HEARINGS

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

PROPOSED LEGISLATION TO CLARIFY THE LAW ON INSIDER TRADING WHICH WILL PROVIDE EVERY PROFESSIONAL AND FIRM ENGAGING IN THE SECURITIES BUSINESS, AS WELL AS EVERYONE ELSE, WITH A SINGLE STATUTE TO DETERMINE WHAT THE LAW IS AND WHAT THEIR LIABILITY IS IN THE AREA. PROSECUTION WILL BE EASIER AND PUNISHMENT WILL BE TOUGHER WHEN THE LAW IS CLEAR

PART I

JUNE 17, 19, 1987

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DEFINITION OF INSIDER TRADING
PART I

WEDNESDAY, JUNE 17, 1987

U.S. Senate,
Subcommittee on Securities,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The subcommittee met at 10:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the subcommittee) presiding.

Present: Senators Riegle, Proxmire, Sasser, Shelby, Wirth, D'Amato, Hecht, and Bond.

OPENING STATEMENT OF SENATOR RIEGLE

Senator Riegle. The subcommittee will come to order.

This morning we begin the first of three hearings on proposed legislation to clarify the law on insider trading. The current epidemic of insider trading is intolerable. This legislation will provide every professional and firm engaging in the securities business, as well as everyone else, with a single statute to determine what the law is and what their liability is in this area. Prosecution will be easier and punishment will be tougher and more certain when the law is clear.

Effective prohibitions are also necessary to preserve the integrity of our capital markets and their ability to serve important national and international economic functions, certainly foremost among them, capital formation.

Insider trading impairs the integrity of our capital markets and is undermining public confidence in them and we mean with this legislation and other companion legislation to deal directly with that problem and to do everything we can to fix it.

In terms of our hearing today, Senator D'Amato laid the foundations for this legislation with hearings that he held in the 98th Congress as chairman of this subcommittee, and we have been working together on this subject since I became chairman in this Congress.

Mr. John Olson also laid the foundations as chairman of the American Bar Association's task force on regulation of insider trading. On February 24 of this year, I requested Mr. Harvey Pitt, a former general counsel of the SEC, to work with Mr. Olson and a group of other distinguished securities lawyers to develop a plain language, workable overhaul of the law applicable to insider trading. I asked them if they would try to have a proposal ready within

90 days. The members of this lawyers' group are among the top securities practitioners in the country. They also represent a diverse set of interests. Some have close ties to industry, others have spent much of their careers as prosecutors at the SEC. Two members were SEC commissioners, one a general counsel, two were directors of the division of enforcement, and one was associate director of that division.

This ad hoc committee went about its task by considering drafts of a proposed statute, discussing the issues in a series of meetings, and arriving at a tentative proposal. The committee sought and received comments on that proposal from persons with ties to a wide range of industry groups. Those comments were circulated and discussed and the committee then adopted its current proposal which they have brought to us.

That these lawyers could develop a consensus definition and still meet the 90-day target date that we had set is a great accomplishment and we thank them for it, and it's a credit certainly to their professionalism.

I believe that this legislation, together with the bill that I introduced with Senator Proxmire and other members of the committee on June 4 on tender offer reform, will not only clarify the law regarding insider trading but will help stop that kind of abuse. It will buttress the prosecution of these cases and I think importantly help restore confidence in our capital markets.

The legislation we introduced on June 4 increases the maximum imprisonment for insider trading from 5 years to 10 years and the maximum fine from $100,000 to $1 million. It also requires a minimum sentence of 1 year for perjury or obstruction of justice in connection with an insider trading investigation.

So if one puts both the tighter and more clearly drawn law together with the tougher penalties in parallel and companion legislation, we start to see how we can really begin through legislative efforts help stop the abuses that have been taking place.

Today we are going to hear from Harvey Pitt and John Olson and we are going to hear from Dean Henry Manne of the George Mason University School of Law, and from Professor Gary Tidwell of the College of Charleston.

For June 19, we have invited witnesses from the administration and the SEC.

Now before yielding to my colleague, Senator D'Amato, I want to make one other comment that relates to this but it's on a different subject because it's topical and it's in the news this morning. That is the story in the Wall Street Journal indicating the intention of the Reagan administration to nominate a candidate to succeed John Shad as the head of the SEC, a professor by the name of Mr. David S. Ruder at Northwestern Law School. I just had it confirmed by phone a short time ago that that information is accurate and he will be formally sent up here as the nominee.

And I must say that this is one of the most important positions in our Government and certainly at a critical time with respect to what's going on in the financial markets and the whole problem—the contagion of insider trading that we have seen. So it's very important that we have someone who has a strong attitude with respect to cracking down on the abuses that have been taking place and who would support a strong enforcement program. And while this is a person of some considerable professional history, it's unclear to me at this point as to whether or not this nominee would bring that kind of strong commitment in that area. I don't know one way or the other, but I know this—that if we were to confirm as an SEC chairman someone who's not prepared to move ahead with the same strength and commitment that John Shad and his people have done, then it would be a real setback to the country.

So we will be examining that with great care and I would hope that we would find that this nominee measures up, but if not, then we will be quite frank in saying so.

With that, let me yield to my colleague, Senator D'Amato.

Senator D'AMATO. Well, Mr. Chairman, let me commend you for moving forward on this legislative initiative and I thank you for having given us such a substantial role in the development of the legislative proposal before us today. I think that we have to undertake more of these legislative initiatives in a bipartisan fashion. So I commend you for that.

Mr. Chairman, I'm going to ask that my complete statement be included in the record as if read in its entirety so that we can hear from the witnesses, but I would like to refer to just a portion of it.

There's a very real question with respect to the clarity of the present law, the definition of what constitutes insider trading. The present state of uncertainty in the law is simply unacceptable.

Now who stated that it's unacceptable? The Supreme Court of the United States has said that it's unacceptable. They said, "Congress, you must give us clearer standards." It said that in the *Dirks* and *Chiarella* cases. So in response to those who say, "You will be providing loopholes by which people can escape the law," I state that this simply not the case.

Prosecutors believe that more clarity is needed. It's one thing for the SEC to bring cases civilly. It's another thing for the U.S. attorney's office in the Justice Department to bring successful criminal prosecutions. The U.S. attorney from the southern district of New York, Rudolph Guiliani, in testimony before this committee, Mr. Chairman, indicated the need for definition. And it's simply absolutely unrealistic to go by the standard which says, "Well, I know it when I see it but I can't tell you what it is. I can't define it." That's nonsense.

Now I recognize that there are legitimate concerns regarding a standard that people can identify. Further, we do not want certain activities to escape the definition and I believe that we have sufficient wherewithal both in this legislation as proposed to address the legitimate concerns of a few of my colleagues who are concerned that the legislation will create loopholes whereby clearly illegal activities would not be covered.

I hope we will continue with the legislation in spite of the heavy schedules and calendars that we have. I am pleased to be a part of this legislative initiative.

[The complete prepared statement of Senator D'Amato follows:]

STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. This morning Senator Riegle and I are introducing the Insider Trading Proscription Act of 1987. We are introducing this bill because it is a needed complement to the Insider Trading Sanctions Act of 1984--a bill which I sponsored, advocated and which was ultimately enacted. At that time I believed and still believe that a definition of insider trading was needed.

Why do I believe this? I think it is clear that the present state of uncertainty about the law is simply not acceptable. The ambiguities about the law were vividly demonstrated in subcommittee hearings earlier where members of the securities industry and securities bar could not specify what conduct constituted insider trading and what conduct is permissible. I believe that an "I know it when I see it standard" is totally unacceptable.

Further, the Supreme Court in the *Dirks* and *Chiarella* cases have requested guidance from Congress in determining prohibited and permissible conduct. Therefore, it is incumbent upon Congress to confront the basic policy questions of what uses of informational advantage are to be forbidden, rather than leaving the law to be developed on a case by case basis.

Some have criticized the legislation because a definition could permit crooks to elude the grasp of the SEC. I think that a failure to clarify the law permits creative lawyers to find loopholes in the legal theories espoused by the SEC. Clarity in the law will not handcuff the SEC. The statute embodies the insider trading theories employed by SEC prosecutors. The application of the statute by the SEC can be applied to novel and unique situations with the increased certainty provided by a congressional pronouncement on the subject. It is time that Congress state the public policy goals that the SEC, the industry and the securities bar should follow in determining what activities constitute appropriate market activities.

This legislation, which we propose as an amendment to the Securities Exchange Act of 1934 in the form of a new section 16A, codifies and clarifies the overarching principles set forth by the courts concerning the scope and purpose of the prohibition against insider trading, while eliminating the ambiguities that emerged from the case-by-case evolution of the law in this area. Indeed, considerable uncertainty permeated the jurisprudence of insider trading precisely because the theories upon which insider trading prosecutions have been founded were developed without the involvement of Congress.

In my view, Congress should take the opportunity to focus on this important issue and put its imprimatur on a legislative approach to prohibiting this brand of unfair dealing in the Nation's capital markets. In discussing the need for statutory definition of insider trading during a February 24, 1987, Securities Subcommittee hearing, there was unanimous agreement that an effort should be made to formulate a precise, plain–English definition of the offense of insider trading, to prevent the fundamental unfairness of prosecuting a crime that has never been defined.

The statute contains two operative provisions. First, the proposed legislation deals with the question of trading by persons who possess material, nonpublic information concerning the security traded. Second, the proposed legislation addresses the communication (or tipping) of material, nonpublic information. In both cases, a broad prohibition is set forth, followed by a statement of defenses and limitations imposed on governmental prosecutions.

This bill is a starting point in our deliberations on an appropriate response to a definition of insider trading. It embodies many of the principles contained in bills I introduced earlier this year.

The legislative proposal will be subject to the subcommittee's closest scrutiny in upcoming hearings. The bill represents our best efforts to provide guidance to the SEC, the courts, the securities industry and the securities bar in their determination of what constitutes permissible and prohibited conduct. The legislative proposal endeavors to establish principles that will be applied to test securities trading activity for possible abuses in cases involving the use of wrongful informational advantage.

Senator RIEGLE. Thank you, Senator D'Amato.

Let me now call on the chairman of the full committee, Senator Proxmire.

Senator PROXMIRE. Why don't you go ahead. I'm not a member of this subcommittee and I'm delighted to wait for the others to make statements.

Senator RIEGLE. Senator Shelby.

OPENING STATEMENT OF SENATOR SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Again, I want to also commend you for your continued leadership in addressing the need to curb insider trading abuses here.

I also want to commend the work and tremendous effort put forth by the members of the Pitt Commission to develop a statutory definition of insider trading. That's no easy task.

The recent insider trading scandals have shaken the very foundation of public confidence in the financial markets. We all know this. Clearly, action must be taken to curb these trading abuses.

In developing a definition of insider trading, we must be careful, however, to strike a balance between the need to eliminate illegal insider trading and the need for the legitimate flow of corporate information in the marketplace. That's hard to do.

Efforts to establish a definition of insider trading have defied Congress in the past.

While Congress failed to enact a definition of insider trading in 1984, Congress indeed did pass the Insider Trading Sanctions Act of 1984 which stiffened penalties in an attempt to deter insider trading. Apparently, these deterrents were not sufficient.

Recent insider trading revelations, including the *Boesky, Siegel* and *Winans* cases, have been the impetus here for Congress to again focus its attention on the need for a statutory definition of insider trading.

It's obvious that the lack of clarity and uncertainty associated with these trading laws and the regulations have been the source of confusion for the securities bar, the industry, and the courts.

This confusion and a lack of full understanding of the law forces many traders to often tread on the edges of the law—edges that can be remarkably rough and sometimes slippery.

These hearings today afford this Subcommittee on Securities the opportunity to explore these problems and to assess the proposals being advanced to give guidance on this complex area of the law.

I welcome our distinguished witnesses, all of you, here today and look forward to your insight on these issues.

Senator RIEGLE. Senator Shelby, thank you.

Senator Bond.

OPENING STATEMENT OF SENATOR BOND

Senator BOND. Thank you very much, Mr. Chairman.

I am very pleased to have the opportunity that these distinguished witnesses before the committee this morning will give in aiding us in our deliberations on insider trading.

I understand that the committee has wrestled with the problem of writing a statutory definition for insider trading some time in the past but it seems to me that the logical place to start with the issue is to consider why we want to ban insider trading in the first place.

Certainly, there will always be individuals with more information about the market than others and an overly broad definition of insider trading could impede market efficiencies by preventing analysts, for example, from uncovering information or discovering useful trends.

On the other hand, a widespread public perception that our markets are rigged will discourage small investors, give them the feeling that they do not have an opportunity, and inhibit the flow of vitally needed capital.

When U.S. Attorney Guiliani was before this committee, he used the example that no one would bet on wrestling matches to illustrate his point, which I found to be appropriate.

I agree that public confidence in our capital markets is essential. Perhaps small investors could feel more comfortable in the fairness of the market if Congress would pass clear legislation defining what is and what is not permissible. If we can craft legislation which clarifies the intent of Congress without narrowing the definition of insider trading too far and letting improper behavior slip through, then we should do so.

The results of Professor Tidwell's survey of stock brokers' knowledge of the law on insider trading certainly support the need for a clear definition of insider trading. If stock market professionals are not entirely sure of what is legal behavior, Congress should think seriously about clarifying the law.

There are proposals before the committee to stiffen the penalties for insider trading that the crime has never been specifically defined. I realize the difficulty in coming up with such a definition. There may be situations which would fall outside of the scope of congressionally prohibited insider trading but in which, like the real recognition of pornography—I know when I see it—the people involved in it know that it's wrong.

I recently read a book by one of the better known journalists whose case is currently before the Supreme Court and he had many theories on why he might be able to avoid the impact of the law, but there is no question from reading that book that he knew it was wrong, the people he worked with knew it was wrong, and we need to be careful in fashioning a precise definition that we don't leave out something such as his action which is clearly wrong.

I applaud the efforts of our chairman and Senator D'Amato in setting up the Pitt Commission and bringing these issues before the committee today. I look forward to the expert testimony of our witnesses and I hope that the committee will be able to move ahead in this very important area.

Thank you, Mr. Chairman.

Senator RIEGLE. Thank you, Senator Bond.

Senator Wirth.

Senator WIRTH. Thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR WIRTH

Senator WIRTH. I want to join with my colleagues in commending you and Mr. D'Amato for working on this issue and again bringing this in front of the Congress.

This is, as you noted and Senator D'Amato noted, not a new issue. In the last few years it has been very carefully and thoroughly discussed.

As I remember, Senator D'Amato had a series of hearings in the early 1980's focused around the then abuses of the statutes by Thomas Reed, who you will remember had worked I believe in the White House and had made an enormous amount of money on an insider tip and the hearings that Senator D'Amato held at that point were very, very helpful to all of us in beginning to define and understand the insider trading issue.

So this committee is certainly no stranger to the issue, nor is the Congress overall. In 1983, we started on both sides of the Hill very extensive hearings on the issue of insider trading. Chairman Shad at that time had said, as I remember, that he would come down on the question of insider trading with hobnailed boots and has done so, and I think that we have a great vote of thanks as well to the chairman and the SEC for being very, very aggressive on this front.

I, myself, approach the question of trying to define insider trading with a good deal of skepticism. When we wrote the legislation in 1983-84, that legislation—you remember, Mr. Chairman—was held up for about a year as the American Bar Association—Mr. Olson, you remember—attempted to define insider trading with, as I remember, no success. And when a number of members of the committee attempted to go back before we got to the floor and define insider trading, again with no success. The consensus was reached 3 or 4 years ago that to attempt to define insider trading more narrowly would be an open invitation to a lot of lawyers to look at that definition and figure out a way of skirting it.

As I remember as well, the Supreme Court, which has been quoted in this discussion here this morning as asking for a greater definition, has in fact made another statement as well. The Court, in talking about the antifraud provisions of the securities law said that those should not be construed, again in the words of the Court, "technically and restrictively, but should be used flexibly to effectuate their remedial purposes."

That's the argument on the other side, that we should have flexibility in this and should not open ourselves up to the potential of abuse by too narrowly defining what is and what is not insider trading.

I think the burden as well lies on us to say, has the fact that there is not an explicit definition of insider trading been a problem? Was the fact that there wasn't an explicit definition of insider trading an open invitation to Mr. Boesky? I think not. I think it was greed, not the statute. Was the fact that there was not an explicit definition an invitation to Mr. Siegle? I think not. I think it was greed, not the law.

So I think that we ought to be very careful in going into this and I appreciate the great efforts that you have put into this, Mr. Olson, and I have worked in the past with Mr. Pitt and have great respect for his capacity. I look forward to the discussions that we will have here to see if in fact we are able to come up with a definition that in "plain language" presents a workable overhaul.

I am skeptical, but if we can do a better job than we've been able to do in the past, I look forward to hearing about it.

Thank you very much, Mr. Chairman.

Senator RIEGLE. Thank you, Senator Wirth. And I know our witnesses, as do all of us, take account of those questions and points that are raised and I think in the course of our discussion this morning we ought to be able to shed some light on those kinds of questions.

Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR HECHT

Senator HECHT. I'd like to join in welcoming our witnesses here today. There is no doubt that we need to come up with a statutory definition for insider trading in order to preserve public confidence in the market and there is no doubt that those that betray the confidence of their customers and colleagues should be tossed in jail and have the keys thrown away.

However, in determining the definition we must be careful not to preclude those who must have information and whose job it is to ferret that information out to the public. By precluding these people, we may end up doing more harm to the public's confidence than any insider trading scandal could ever do.

I look forward to hearing your testimony. Thank you.

Senator RIEGLE. Senator Sasser.

OPENING STATEMENT OF SENATOR SASSER

Senator SASSER. Well, thank you very much, Mr. Chairman. I want to commend both you and the ranking member, Senator D'Amato, for your efforts in this field and for calling these hearings.

I am pleased that the committee is going to examine, beginning today, the issue of the definition of insider trading. I think there's confusion and a great deal of ambiguity concerning what constitutes insider trading.

And it's my view, Mr. Chairman, that this has hampered enforcement of the law at the very time when insider trading appears to be rampant.

I do believe it's critical that we in the Congress make sure that insider trading abuses are addressed quickly and decisively and to that end we are holding these hearings today. There's a lot at stake. The integrity of the stock market is at stake. The very foundation of our country's capital-raising process I think it's not an overstatement to say is called into question and we need this capital-raising process to raise the capital to create jobs for our work force and for all of our citizens.

And under the present circumstances, a strong case can be made that the average American will not participate in the stock market when he or she sees a select few insiders have access to, quite frankly—and I don't think this is any overstatement—the ability to steal based on superior information on market developments.

So I think, Mr. Chairman, the work that we are engaged in this morning is very important and I look forward to hearing from our witnesses as these hearings progress. Thank you.

Senator RIEGLE. Thank you, Senator Sasser.

Senator Proxmire, our full committee chairman.

Senator PROXMIRE. Thank you very much, Chairman Riegle.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Senator Riegle and Senator D'Amato, I want to commend you for your efforts in seeking a statutory clarification of our laws on insider trading. You have enlisted the help of some of the finest securities lawyers in the country, a group that combines a strong background in enforcement with extensive experience in representing private clients. Your objective is worthy, it's important, and—I agree with Senator Wirth—it is very, very tricky.

Any statutory definition will be dissected by clever, highly paid legal definition experts. If there's a loophole to be found, they will find it and they will make millions out of finding it. If they can't find it, they may even invent it.

I hope that these hearings will develop a broad consensus on a definition of insider trading, a consensus that will include the Securities and Exchange Commission and its Division of Enforcement. If we can achieve that kind of consensus, I anticipate the committee can act on this legislation effectively. You can count on my strong support for a tough bill that gives the prosecution the tools it needs to crack down on those individuals and institutions who are too greedy to make money the old-fashioned way. Thank you.

Senator RIEGLE. Thank you, Senator Proxmire. If I may just on one of the important points you make, we are in the process of asking the SEC for an official response on this and feel, as you do, it's very important that we have that and that we have it in the proper form. And assuming that we are able to get that and with whatever modifications along the way, I appreciate your indication of a desire to be prepared to move ahead if we can be sure that we have legislation here that is sound and is in the public interest and that willingness to so indicate is very helpful I think.

At that point, let me now turn to our witnesses and let me say again how much I appreciate the time and the effort that's gone in and the personal leadership on both your parts in producing the work product that underlies this legislation and I want to, through you, thank the other members of the group that participated. They also gave at great length of their time and professional knowledge to help us move forward.

I'm going to start with you, Mr. Pitt, but there is one specific matter that I'd like to ask you to touch on in your presentation. That is, with respect to the way the laws would work, assuming we were to pass this legislation and we were to establish this clearer legal definition out there, if some unscrupulous person using the creativity of their mind were to figure out a way to violate the law and to take advantage unfairly in a stock trading situation that is not explicitly covered under what we have drafted here, how would that situation be dealt with? How would we envision that kind of problem?

I think this is one way of framing the issue of whether or not you can write a definition that in a sense is equal to the deviousness of a person with a corrupt motive, and obviously it's probably impossible to do that; but the question of how the insider trading law under this proposal would reach that new and novel attempt to find a way around even that written law is something I think we really need to nail down today. So at whatever point is appropriate, I'd like you to incorporate a response to that in your remarks. But let us hear from you now.

STATEMENT OF HARVEY L. PITT, PARTNER, FRIED, FRANK, HARRIS, SHRIVER & JACOBSON, WASHINGTON, DC

Mr. PITT. Thank you, Mr. Chairman and members of the subcommittee. My name is Harvey Pitt and with me is John Olson. We are pleased to have this opportunity to testify on the proposed Insider Trading Proscriptions Act of 1987, a statute that's designed to set forth in plain English the definition of, and prohibitions against, what is commonly referred to as insider trading.

As I listened to the opening remarks, I must say that I was reminded of the diversity of views between those who talk about an idea whose time has come, and I think it was Janeway who referred to "Nothing quite as apocryphal as an idea that won't go away." It's our view that this is an idea whose time has come and we hope that this committee will share that.

Since I assume that our detailed joint written statement concerning this important legislation will be made part of the subcommittee's hearing record, we will not repeat those comments now, nor do I intend to belabor this hearing with a lengthy recitation of either Mr. Olson's considerable background and expertise, or my own somewhat more modest accomplishments.

It suffices, I trust, for me to note simply that we are both corporate lawyers with large, multicity law firms, are both active in and chair relevant committees of the American Bar Association, and are both conversant with the current state of the law on insider trading, and I might add, its considerable deficiencies. The views we will present today, however, are ours alone and do not necessarily represent those of our respective law firms, clients of those law firms, or other members of the legislative committee that we will be describing shortly.

In the time allotted, I will discuss briefly the background of the proposed legislation, the specific issues that it addresses, and how the proposed statute would change or affect existing law. Mr. Olson will discuss the need for a statutory prohibition against insider trading and certain of the procedural issues this proposal would resolve. I would like then to close with a concluding thought in our oral statement.

I do want to address, however, before I start, two specific points, since I always find it more effective to deal with the questions the committee has in the order that you have raised them than in the order that we started with.

The first is the chairman's question which is, what if some unscrupulous person came up with a devious method to evade this definition?

Let me answer that in several ways and I encourage John to participate with me. First, I think the definition has been drawn sufficiently broadly that it covers most of the kinds of theories that the Government has come up with under current law that we think would deal with a broad variety of these types of situations.

STATUTE HAS TWO IMPORTANT CHANGES

However, the statute has two important changes which I think Senator D'Amato referred to when he referred to the Supreme Court. First, there would be congressional findings in this statute that make it clear that this committee and the Congress think insider trading is wrong and the reasons why this committee thinks it's wrong. That has never been done before and the absence of those provisions have resulted in two major defeats for the Government in prosecutions in the Supreme Court. And if I am a soothsayer and I don't know whether I am or not, I would say that they are headed for a third or at least not a very significant help in the *Winans* case.

Given those findings, the statute would specifically give the SEC rulemaking power to implement the specific findings that Congress has set forth in the statute and I might add here that the important thing that the Supreme Court has said has been missing from current law is any view by the Congress that the real problem with insider trading is its effect on the integrity and the fairness of the marketplace. This statute would for the first time articulate that.

While I am largely a corporate lawyer, as I suspect this committee is aware, I've been involved in some insider trading matters in the recent past and I would say, as a defense lawyer—and some might dispute how highly paid——

Mr. OLSON. Only your family.

Mr. PITT [continuing]. But as a defense lawyer, I would say I would much prefer to be defending insider traders or persons accused of insider trading under the current law than I ever would be under this proposal.

We took our mission that this subcommittee gave us very seriously. I drafted this the same way I would have drafted it as if I were still at the SEC and its general counsel, and I believe every member of our committee—John Olson, who played a major role in constructing it with me and the others—did exactly the same thing, and then we ventilated it with SEC people, academics, industry people and the like. And I believe that this is an idea whose time has come and one that can be implemented with great confidence by this committee as establishing its imprimatur on what the law ought to be and the reasons why the law is presently deficient.

Let me take a moment now, having responded I hope, Senator Riegle, to the specific points you raised, just to set a little bit of background and set some of the origins for the proposal.

During my testimony before this subcommittee on February 24, 1987, I criticized the current state of law on insider trading. Senator Riegle asked if I would undertake, with a group of lawyers expert in this field, to formulate a precise, plain English definition of the offense of insider trading and related prohibitions. To that end, a committee of lawyers selected at the suggestion of the subcommittee has met over the past 3 months to discuss and prepare a proposed statute to define and prohibit insider trading and tipping, and we have attached a list of the people.

Our methodology involved circulating to our committee's members various relevant materials, including the I think now landmark report of the American Bar Association's task force on the regulation of insider trading that John Olson chaired. We also relied heavily upon the pioneering legislative proposals of Senator D'Amato. I might add that we have had at all times—and I want to return in a sense the compliment—the unstinting support of this committee, Senator Riegle in particular, as well as Senator D'Amato and members of this subcommittee's staff—Steve Harris, Tom Lykos, and Rick Carnell, among others. That support has been invaluable and has enabled us to progress and to keep our committee meetings decorous. You would be surprised how emotional securities lawyers can get about this subject. We have also had the participation of SEC staff people on an unofficial basis and I do want to stress that. No member of the SEC staff is a signatory to this proposal, although I believe, as the chair of the group, that we did accommodate all of the governmental concerns.

The draft proposal, after fine-tuning and adjustment, was circulated for comments to individuals with ties to a broad cross section of industry groups that were likely to have an interest in legislation of this sort—securities firms, the SIA, the New York Stock Exchange, banks, mutual funds—all through the country. We reviewed the comments that were received in response to the exposure draft and I believe we made appropriate responsive adjustments. The product of that process, the Insider Trading Proscriptions Act of 1987, is now before this subcommittee.

Before I offer an overview of how the statute would operate and how they would change or affect current law, I should like to ask Mr. Olson to discuss the need for a statutory prohibition against insider trading and related offenses, and to explain the reasons that we believe militate strongly in favor of the adoption of such legislation and its adoption now.

Senator RIEGLE. Mr. Olson.

STATEMENT OF JOHN F. OLSON, PARTNER, GIBSON, DUNN & CRUTCHER, WASHINGTON, DC

Mr. OLSON. Mr. Chairman, Senator D'Amato, members of the subcommittee, I would like to join Harvey Pitt in giving special thanks to the members of your staff who worked so closely with us throughout this process. Messrs. Harris, Lykos and Carnell attended all or almost all of our meetings and were of immense help to us in understanding concerns of the kind that you expressed and the kind that Senator Wirth and Senator Proxmire expressed. As Harvey has told you, we have drafted what we believe is a workable, expansive definition reflecting the law as it has developed but making that law much clearer, much more readily used by prosecutors, and much more predictable for defendants. It's a living kind of statute. It's a statute that is not narrow. It is not technical. It is based on concepts such as those developed in the second circuit which do allow the Commission and the U.S. attorneys to go after the novel situation that wasn't anticipated by the draftsmen. It is not a code that tries to specify exactly what kind of thing is going to be caught and what is not.

It sets forth general legislative findings about the integrity of the markets, which as Harvey has said, have not been ever made by the Congress officially, and it sets forth general principles which can be applied by judges in a rational and consistent and predictable manner, something which has been missing from the law to date.

In 1984, an American Bar Association task force which I chaired was appointed, as Senator Wirth has said, sort of midway through the process of considering the Insider Trading Sanctions Act because there was a widespread belief in the bar that it was inappropriate to substantially increase penalties for an offense that we could not define.

A former SEC Commissioner, Irv Pollack, who is also a former Enforcement Director, a number of distinguished securities lawyers, other former senior SEC officials, and current members of the staff on the basis of consultants, joined with us in that task force effort.

We printed our report in November 1985 long after the Insider Trading Sanctions Act had been adopted and so our recommendations played no role in the adoption of that statute. They were prompted by the statute but were not considered at the time the statute was before the Congress.

DEVELOPMENT OF LAW RESULTS IN CONFUSION

Based on our study, we concluded that the development of the law in the courts had resulted in confusion, controversy, and substantial ambiguity as to what was and what was not prohibited. As just one example, the Supreme Court has twice recently been asked to address uncertainties in the law—in the *Chiarella* case in 1980 and the *Dirks* case in 1983—and in both these instances, the Supreme Court has reversed lower court holdings of liability and defendants have been set free.

Since our task force report was issued, the Court has now taken the *Winans* case and will decide whether to affirm the criminal convictions of Mr. Winans and others some time next year. In the *Winans* case, there was a strong dissent by one of the three judges in the second circuit arguing that the law of insider trading as it exists today simply did not reach Mr. Winans' conduct. No one knows what the Supreme Court will do, but those who follow the Court say it didn't grant cert to simply affirm what had been done below. So the expectation must be that either it will reverse or that it will clarify the law in a direction which can't now be predicted. In the meantime, the ambiguity and the unpredictability continue.

Our task force concluded in 1985—and I think it is even more true today—that the present state of uncertainty about the law simply is not acceptable. The present ambiguity creates problems for prosecutors and it creates problems for securities professionals who legitimately want to obey the law but cannot be sure what it is.

As we concluded in 1985, "Congress can and should confront the basic policy questions of what uses of informational advantage are to be forbidden, rather than leaving the law primarily to case by case development."

Having issued that challenge to the Congress, I suppose it is only a fair return that Senator Riegle and Senator D'Amato sent the challenge right back to us and said, "If you feel that way, see what you can come up with."

If the Congress waits for the Supreme Court to decide the *Winans* case before addressing these critical definitional issues, we will face not only a delay of as much as a year in clarifying the law at a time when the Commission and the U.S. attorneys' prosecution program is uncovering more problems daily, but also very real risks that the Court's decision either will not give clear guidance because of the unusual facts of Winans or, possibly, of divergent views among the justices, as happened in the earlier cases; or, if the defendants prevail and the case is reversed, the Government's use of the misappropriation theory in all of its pending cases will be put very much at risk and its prosecutorial program put into a state of chaos.

These prosecutorial concerns are very important as a matter of public policy, but they are only part of the problem with the present unsettled state of the law. There is also the question of due process. It is fundamentally unfair and contrary to our constitutional traditions, it seems to me, to impose very substantial jail sentences and fines—and the Congress has before it bills that would increase those penalties again and rightly so—but to impose those penalties for a crime that has never been clearly defined.

We have often said that our system is one of a Government of laws and not of men, that we can do in our society what is not prohibited. In other societies, one can do only what is permitted. In a constitutional system where we value civil liberties highly, the failure to define a crime which is at the heart of a major government prosecution program is just not acceptable.

INSIDER TRADING PROMOTES MARKET EFFICIENCY

Finally, there are still those, including some eminent legal scholars and economists, one of whom I gather you are going to hear from this morning, who argue that there's nothing wrong with insider trading, that indeed it promotes market efficiency. Leaving aside for a moment the fact that this is a nation of morality, a nation of law, and those fundamental concerns, from our practical standpoint, our task force which studied this subject for a period of more than a year considered those arguments, read all the literature and all of the research done in the area, and we concluded that the integrity of the markets and the public belief in that integrity far outweighs any possible economic advantage that might be gained from a reflection of nonpublic information in the market at an earlier date as a result of illegal insider trading. We reject those arguments and we believe it is time for the Congress speaking for the Nation to reject them as well, with a clear policy statement and a clear definition of insider trading.

Mr. Pitt is now going to briefly summarize the major operative provisions of the proposed Proscriptions Act that you have introduced, indicating the way in which it will address some of the problems in the present ambiguous state of the law. Harvey.

Mr. PITT. Senator Riegle, let me just ask—I know that we are here really to respond to the committee's questions. We had planned to go through an overview of some of the provisions, but if time is of concern, I would be happy to turn to questions and I know John would be as well instead of going through a detailed outline. But if not, I have a brief outline of the statute and I leave it to the committee's pleasure as to how you would like to proceed.

[Joint written statement of Harvey L. Pitt and John F. Olson follows:]

JOINT WRITTEN STATEMENT OF HARVEY L. PITT AND JOHN F. OLSON BEFORE THE SECURITIES SUBCOMMITTEE OF THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE REGARDING "THE INSIDER TRADING PROSCRIPTIONS ACT OF 1987"

(June 17, 1987)

INTRODUCTION

Mr. Chairman, Members of the Subcommittee:

We are pleased to testify before you today on the "Insider Trading Proscriptions Act of 1987," a bill that would, if enacted,

> (i) set forth Congress's firm opposition to the misuse of material nonpublic information relating to publicly traded securities;
>
> (ii) set forth the precise standards by which such misconduct could be prosecuted civilly and criminally;
>
> (iii) clarify ambiguities in the application of current laws against such conduct; and
>
> (iv) create a private remedy for those injured by such activities.

The bill reflects legislation drafted at this Subcommittee's request by a committee of lawyers (the "Legislative Committee").[1] The views we present today, however, are solely our own and do not necessarily represent the views of

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[1] A list of Legislative Committee members is annexed as Exhibit 1.

any other member of our Legislative Committee, our respective law firms or any client of our respective firms.[2]

I. EXECUTIVE SUMMARY

The current prohibition against insider trading, having emerged as a creature of piecemeal "judicial legislation" based on the broad antifraud provisions of the Securities Exchange Act of 1934 (the "Exchange Act"), is unclear in its scope, reach and philosophical underpinnings.

The "Insider Trading Proscriptions Act of 1987," introduced today, would supply much-needed certainty to this important aspect of the federal regulatory scheme governing the nation's capital markets.

An explicit codification of the prohibition against insider trading will

> (a) enhance the government's enforcement program by defining the offense and its underlying public policy goals;
>
> (b) provide guidance to those who wish to obey the law; and

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[2] Brief biographical descriptions of Messrs. Pitt and Olson are annexed as Exhibits 2 and 3, respectively. Messrs. Pitt and Olson gratefully acknowledge the unstinting assistance of Karen L. Shapiro in preparing this statement.

(c) end the possibility of fundamentally unfair criminal prosecution of a common law crime with unknowable dimensions.

Over the past several months, the Legislative Committee, selected at the suggestion of the Securities Subcommittee, under the leadership of Senators Riegle and D'Amato, has met to formulate a statutory definition of, and prohibition against, insider trading and related abuses of material, nonpublic information. The draft statute produced by the Legislative Committee was widely circulated among various industry groups and securities law practitioners for comments. After considering the responses to the exposure draft of the statute, the proposed legislation was put into final form for transmittal to Senators Riegle and D'Amato.

As is suggested by the Subcommittee's request for a proposed legislative definition of insider trading, Congress should act now to clarify and emphasize the prohibition against insider trading, rather than awaiting the outcome of any particular case. Indeed, much of the ambiguity that permeates the jurisprudence of insider trading has resulted from the piecemeal, case-by-case development of law in this core aspect of the federal securities laws, based on narrow decisions as to specific factual issues. Moreover, in so important an area of

law, "judicial legislation" is an inappropriate manner of developing national policy guidelines.

Rather, we believe that comprehensive consideration of the issue by Congress is essential to the development of consistent, rational principles to govern this area of the law. Further, the passage of appropriate legislation would eliminate the difficulties associated with developing a regulatory framework by means of litigation and enforcement proceedings, such as the consequences to the government of unfavorable decisions, and the perceived unfairness to the person who provides the government with its "test case." Fundamental fairness and due process require that the elements of a crime be sufficiently defined in advance of prosecution. There is ample testimony that, under current law, the reach of the prohibition against insider trading is unclear. Thus, it is time to face squarely the task of defining the offense of insider trading with sufficient specificity and precision to make the requirements of the law clear and unambiguous.

The proposed "Insider Trading Prohibitions Act," which will be introduced today, provides a clear, plain-English definition of the offense of insider trading, in a formulation that will enable the government to prosecute any case that is legitimately within its reach under existing law.

The proposed legislation commences with clear Congressional findings that insider trading is wrong.[3/] The findings underscore the harm to the fairness, honesty and integrity of the nation's securities markets that flows from insider trading, the need for legislation to prevent or redress such harm, the importance of a well-informed market and the need for clarity in the law.

The proposed legislation contains two operative prohibitions. The first substantive proscription is directed to wrongful trading on the basis of material, nonpublic information.[4/] This section broadly defines the term "wrongful" to embrace any direct or indirect theft or misappropriation of information, or any use of information that is inconsistent with a relationship that implies a duty not to so use the information.[5/] This provision also creates a

statutory presumption that anyone who trades in securities while in possession of material, nonpublic information about the securities has actually used that information in connection with the transaction; a defense to that presumption is created for non-natural (or institutional) persons who can prove that (i) the transactions in question were not influenced by the nonpublic information and (ii) the persons effecting the trades (or causing them to be effected) did not know the information.

The second operative provision of the statute contains two "anti-tipping" prohibitions.[6/] The first is a broad prohibition against the wrongful communication of material, nonpublic information, where the communicator knows (or is reckless in not knowing) that the communication would (and in fact does) lead to a trade in the affected securities. This provision has been carefully designed to protect the ability of corporate officials to provide information to securities analysts and others similarly situated, since such communications are not made with a view to facilitating the analysts' personal securities trading.

[3/] These findings are set forth in subsection (a) of the proposed legislation.

[4/] The prohibitions against wrongful trading are set forth in subsection (b) of the proposed legislation.

[5/] Thus, the statute codifies and defines in plain language the so-called "misappropriation" theory, an administratively- and judicially-created common law theory of liability on which virtually all recent government insider trading prosecutions have been predicated.

[6/] These "anti-tipping" proscriptions are set forth, respectively, in subsections (c)(1) and (c)(2) of the proposed legislation.

The second "anti-tipping" provision is more narrowly tailored, to address the widely-perceived abusive practice by so-called corporate raiders of putting public companies "into play" by tipping inside information about possible takeover plans to third parties, in an effort to stimulate active interest and activity in the target company's stock. Communication of such information for the purpose of influencing securities transactions by persons not expressly acting as part of a potentially disclosable group with the communicator is specifically prohibited.

Having defined violative conduct, the proposed legislation resolves the very difficult problem of derivative liability on the part of institutions that do nothing more than suffer the misfortune of having employed someone who is found to have engaged in illegal insider trading. Thus, the statute contains an exemption from derivative liability for persons who employ or control persons who violate the insider trading prohibition, so long as the employment or control relationship is the only nexus to the person who committed the violation.[7]

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[7] Subsection (d) of the proposed legislation sets forth this exemptive provision.

In addition, the statute sets out carefully-tailored rulemaking authority to be vested in the Securities and Exchange Commission (the "Commission" or the "SEC").[8] This grant of authority, which is intended to guide the Commission's regulatory efforts along the path of the Congressional findings, allows the Commission to implement the provisions of the Act and to exempt persons, transactions and classes of persons and transactions from the reach of the statute where such exemptions comport with the intended reach of the statute. The SEC's generic rulemaking authority, set forth in Section 23 of the Exchange Act,[9] would not be applicable to the proposed legislation.

Contrary to the current situation, the proposed legislation expressly would provide a private remedy to anyone who is injured by an insider trading violation.[10] This measure gives the persons intended to be protected by the legislation a mechanism for invoking that protection, and at the same time recognizes the enormous benefits of private, as well as governmental, vindication of the remedial purposes of the Act.

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[8] See subsection (e) of the proposed legislation.

[9] 15 U.S.C. §78w (1982).

[10] See subsection (f) of the proposed legislation.

Finally, the statute specifically states that the prohibitions contained therein shall provide the exclusive federal standards for actions alleging insider trading.11/ This exclusivity provision, while necessary to assure the intended clarity in the law, has been drafted to ensure that the Commission will be fully able to use the broad existing antifraud provisions of the Exchange Act to reach other novel abuses that may include, among other elements, the misuse or improper communication of material, nonpublic information.

We believe that the Insider Trading Proscriptions Act provides, in plain English, a comprehensive approach to resolving the ambiguities in the existing jurisprudence of insider trading and will enhance the government's enforcement efforts as well as provide guidance to the public as to the requirements of the law.

11/ See subsection (g) of the proposed legislation.

II. DESCRIPTION OF THE COMMITTEE'S METHODOLOGY

At the request of this Subcommittee, made during the testimony of Mr. Pitt on February 24, 1987, a committee of lawyers, selected at the suggestion of the Subcommittee, was convened to draft legislation to correct perceived deficiencies in the current laws used to prosecute insider trading and related market abuses.12/ Observers from the SEC and the Subcommittee's staff attended the Legislative Committee's meetings and provided informal reactions to the development of the proposal.13/

Prior to the first meeting of the Legislative Committee, various materials were circulated for review, including the ABA Insider Trading Task Force Report;14/ relevant excerpts from the American Law Institute's proposed Federal Securities Code; various existing and proposed foreign statutes containing

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12/ See Exhibit 1.

13/ In no sense, however, is the proposed Insider Trading Proscriptions Act a product of either the Commission's staff or the Subcommittee's staff.

14/ Report of the Task Force on Regulation of Insider Trading (Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934), 41 Bus. Lawyer 223 (Nov. 1985)(the "ABA Task Force Report").

prohibitions against insider trading; and the Report of the Criminal Law Committee of the Association of the Bar of the City of New York, recommending a criminal insider trading statute based on the report of the ABA Task Force. Considerable guidance for the Legislative Committee's deliberations was provided in legislation introduced by Senator D'Amato, in his pioneering efforts to bring much-needed certainty to this important area of law.[15]

Thereafter, a drafting subcommittee, including Theodore A. Levine and the two of us, reviewed a number of drafting suggestions and prepared initial drafts of a comprehensive statute. These drafts were circulated to the full Legislative Committee for discussion and resolution.

The full Legislative Committee met on five occasions to identify issues requiring further deliberation and to determine the appropriate language for an exposure draft of a proposed statute.[16] Further refinements to the draft were effected

outside formal Legislative Committee meetings and circulated among Legislative Committee members and observers for their review and reactions.

The Legislative Committee also had the opportunity to interact with the Legal Advisory Committee of the New York Stock Exchange, whose excellent efforts to formulate a statutory definition of, and prohibition against, insider trading were spearheaded by Richard M. Phillips, who also assisted us as a member of the Legislative Committee.

Upon arriving at a consensus as to the language of the proposed statute, an informal exposure draft of the proposal was widely circulated for comments among individuals with ties to a broad cross-section of industry groups that would likely have an interest in any such legislation.[17]

The comments received in response to the exposure draft of the proposal were circulated to, and summarized for, the Legislative Committee, which met a final time to evaluate the issues raised in the comments and to incorporate into the draft statute appropriate, responsive adjustments. This methodology produced the proposed "Insider Trading Proscriptions Act of 1987," which was transmitted (together with supporting materials) to Senators Riegle and D'Amato on June 9, 1987, on behalf of the Legislative Committee.

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[15] S. 230, 100th Cong., 1st Sess. (1987); S. 231, 100th Cong., 1st Sess. (1987).

[16] Those members of the Legislative Committee who attended the American Bar Association Spring Meeting in St. Louis during the week of April 6, 1987, met on this additional occasion, to discuss further the development of the proposal.

[17] A list of those individuals who provided comments in response to the draft is attached hereto as Exhibit 4.

III. BACKGROUND

The federal securities laws do not define, or in specific terms prohibit, so-called "insider trading," or the misuse of material, nonpublic information relating to publicly traded securities. Rather, the evolving definition of the offense has emerged from SEC and judicial decisions, premised on the sweeping antifraud provisions of Section 10(b) of the Exchange Act,[18] and Rule 10b-5 thereunder,[19] which, beginning about forty years ago, were construed as embodying a prohibition against trading by corporate insiders in their own securities while in possession of material, nonpublic information concerning such securities.

Ironically, Section 10(b) was intended by its original drafters to be a "catch-all," pursuant to which the SEC could

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[18] 15 U.S.C. § 78j(b) (1982).

[19] 17 C.F.R. § 240.10b-5 (1987).

prosecute novel and unanticipated forms of securities-related misconduct not specifically proscribed by the precise provisions of the Exchange Act.[20] Recent events, however, make clear that insider trading is not a rare type of abuse that appropriately should be treated as peripheral to the major protections of the Exchange Act, or prosecuted pursuant to a "catch-all" statutory proscription that lacks legislatively-articulated contours and carefully-drawn standards. Governmental prosecutions in this core area of securities law need a more certain footing.[21]

In 1984, the Congress, consistent with the views of the Commission's then Director of Enforcement, expressly declined to include in the Insider Trading Sanctions Act of 1984 a definition of the predicate offense of insider trading.[22] Thus, the current law in this very important area of the federal securities laws has developed as a creature of "judicial legislation," without any guidance from the Congress.

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[20] *Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce*, 73rd Cong., 2d Sess. 115 (1934)(testimony of Thomas G. Corcoran).

[21] It is telling that, in the last seven years the Supreme Court has granted review of three government insider trading prosecutions on the ground that the statutory predicate for such prosecutions was vague or ambiguous. In the first two cases, the Court reversed findings of violations. *Chiarella* v. *United States*, 445 U.S. 222 (1980); *Dirks* v. *Securities and Exchange Commission*, 463 U.S. 646 (1983). The third case is pending, but is widely assumed to raise the same concerns. *United States* v. *Carpenter*, 791 F.2d 1024 (2d Cir.), *cert. granted*, 107 S. Ct. 666 (1986).

Congress has never set forth the public policy behind prohibitions against so-called insider trading, or articulated the theories that should define the contours of the offense. And many of the cases which have been most notorious in recent years -- including those in the headlines over the past two years -- have not involved corporate insiders at all, but rather various types of outsiders, such as financial printers, investment bankers, lawyers, arbitrageurs, reporters and others, who have been held to have abused an informational advantage. The purpose and scope of the law has been determined on a case-by-case basis rather than by the application of a coherent and cohesive legislative standard.

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[22] The Insider Trading Sanctions Act of 1984: Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 98th Cong., 2d Sess. 37 (Apr. 3, 1984) (testimony of John Fedders). The Insider Trading Sanctions Act is codified at 15 U.S.C. §78(d)(2)(A) (Supp. II 1984).

As a result of this piecemeal judicial development of the law, considerable ambiguity permeates the jurisprudence of insider trading. While there may not be disagreement as to what types of conduct will be found to constitute egregious wrongdoing, the outer limits of permissible conduct by persons who desire to conform their conduct to the requirements of the law remain uncertain.

Among the specific questions that remain unclear or unanswered under current law are the following:

- Whether the so-called misappropriation theory is an appropriate basis for insider trading liability;[23]

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[23] The "misappropriation" theory was initially devised by the government as an alternative theory to sustain the criminal conviction of Vincent Chiarella, a financial printer who abused his earlier access to nonpublic information about pending corporate takeovers to profit personally by trading in advance of the public announcement of the proposed takeover. The theory was held not to have been presented to the jury, and thus could not sustain Mr. Chiarella's conviction. Chiarella v. United States, 445 U.S. 222 (1980). Since that time, the government has developed the "misappropriation" theory by tailoring it to the specific facts of particular cases. While the lower courts have accepted this process, the Supreme Court has yet to confront the theory squarely. But cf., Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 215, 105 S. Ct. 2622, 2630 (1985). The Court has, however, granted a writ of certiorari in the Winans case, a case that relies exclusively on the misappropriation theory to sustain Mr. Winans' conviction under Section 10(b) and Rule 10b-5.

- If the misappropriation theory is an appropriate basis for insider trading liability, what breaches of duty will sustain a government charge of liability;
- What actions and states of mind of tippers who do not trade, and tippees who do, are required to impose liability;
- When, and under what circumstances, will mere silence alone constitute a breach of duty;
- To what extent will trading while in possession of inside information be deemed to be trading on the basis of that information and, thus, result in insider trading liability;
- When, and under what circumstances, will institutions that employ persons who engage in illegal insider trading clearly be liable for the wrongful acts of their employees;
- Whether, and on behalf of whom, a private right of action for injuries sustained as a result of insider trading exists;
- To what extent will persons who engage in illegal insider trading be held liable for civil damages (in addition to the disgorgement of ill-gotten gains at the behest of the Commission, and the imposition of treble civil penalties under the Insider Trading Sanctions Act of 1984);
- What statute of limitations is applicable to any private right of action for alleged insider trading; and
- To what extent does the Commission have the authority to exempt certain transactions from the reach of any insider trading prohibition.

These ambiguities -- and others -- in the current state of the law create problems both for prosecutors -- who must predict what judges will do with new fact situations, before bringing a case -- and, equally important, for citizens, especially securities professionals -- who lack the guidance of a known standard to which they can conform their conduct. To any person concerned with civil liberties, it should be deeply troubling that people can be prosecuted, and subjected to increasingly severe penalties, for a crime that the Congress has never defined.

Thus, an explicit codification of the prohibition against insider trading is unquestionably necessary, to

(a) give government prosecutors a well-defined statutory tool, backed by explicit Congressional public policy findings, that will enhance the government's insider trading enforcement program;

(b) provide meaningful guidance to those who wish to obey the law; and

(c) eliminate the risk of fundamentally unfair criminal prosecution of a common law crime with unknowable dimensions.

Significantly, the proposed statute before you will not cut back on the law as it has developed to date. The major insider trading cases legitimately brought by the SEC and the United States Attorneys in recent years, including those based on the "misappropriation" theory, could still be maintained under the statute our Legislative Committee has drafted. Indeed, because its contours are clearer than present law, prosecution under the proposed law should be simplified while, at the same time, giving fair warning to the public of the conduct that is forbidden.

IV. WHY CONGRESS SHOULD ACT NOW

It has been suggested by some that, perhaps, any effort to draft insider trading legislation should await the outcome of the Supreme Court's decision in the case of United States v. Carpenter (often referred to as the Winans case).[24/] The

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[24/] United States v. Winans, 612 F. Supp. 827 (1985); aff'd in part, sub nom. United States v. Carpenter, 791 F.2d 1024 (1986), cert. granted, 107 S. Ct. 666 (1986). In the Winans case, the prosecution alleged that Winans, one of the authors of the Wall Street Journal's (the "Journal") "Heard on the Street" column, had misappropriated from the Journal information concerning "the timing, content and tenor of market-sensitive stories scheduled to appear in the paper." 612 F. Supp. at 829. The "Heard on the Street" column, a daily "market gossip" section, was widely recognized as exerting an influence on the market for the securities that were the subject of the column. Id. at 830. Thus, by alerting several acquaintances to expected market price movements in advance of publication of the columns that would cause the price movement, Winans and his confederates reaped substantial illegal profits. A key fact in the outcome of the decision in both the District and Circuit Courts was the finding that the Journal had implemented, and Winans knew of, a strict confidentiality policy concerning information generated or learned in the

Footnote Continued

unusual facts of Winans are such that even an unqualified affirmation of the opinion rendered by the Second Circuit could well result in narrow guidance from the Courts applicable only to those cases with similar facts.

Despite the broad endorsement of the misappropriation theory by the District and Circuit Courts in other cases, the result in Winans has, thus far, largely turned on the fortuity of the Journal's explicit conflicts of interest policy. Had there been no such policy in effect with respect to the Journal's financial reporters, it is questionable whether Winans could have been prosecuted under any of the government's theories, notwithstanding the self-confessed wrongfulness of his actions.[25/]

Moreover, as we have pointed out above, even if the Supreme Court should affirm the Second Circuit's opinion in

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24/ Footnote Continued From Previous Page

course of employment. The Journal's conflict of interest policy admonished that "all material gleaned by or in the course of your work for Dow Jones is deemed to be strictly the Company's property." Id. Winans was found guilty of criminal conspiracy, criminal securities fraud and criminal mail and wire fraud. Id. at 850.

[25/] See R. Foster Winans, Trading Secrets: Seduction and Scandal at The Wall Street Journal (St. Martin's Press, 1986).

every respect and without any qualification or limitation, "judicial legislation" is simply the wrong way to make law, especially where such law will form the basis for criminal prosecutions.

Further, a decision in the Winans case will still leave unresolved most of the present ambiguities in insider trading law. Although tipping occurred in that case, the questions presented to the Supreme Court for its review do not go to the scope of, or the standards for, tipper or tippee liability. Thus, the ambiguities left open in the Court's earlier Dirks decision almost certainly will not be resolved in the Winans case.

Finally, given the serious concerns about notice expressed by the Supreme Court in the past, any decision rendered by the Court in the Winans case could well limit the reach of the misappropriation theory -- that is, the Court might find that the misappropriation theory has not yet been sufficiently developed or adequately articulated to provide proper notice that the conduct at issue was criminal. The Court has, in the recent past, reversed a criminal securities fraud conviction

based on a determination that the defendant was not given sufficient notice that his specific actions were unlawful.[26/]

We wish to make it quite clear that we share the Supreme Court's reticence in that regard. We find it troublesome that a government agency, having declined to use its regulatory authority affirmatively to promulgate standards to govern certain types of conduct, sets out to develop such standards through enforcement proceedings or civil or criminal litigation. The development of legal standards in the context of punitive enforcement proceedings is bad business, and is especially unfair to those persons who provide the government with the "test case" for a novel theory.

The recent case of Dirks v. Securities and Exchange Commission illustrates the problems created for prosecutors when test cases are lost in the courts and the effects are felt

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[26/] See Chiarella v. United States, 445 U.S. 222, 235-37 n.20 (1980) ("[A] judicial holding that certain undefined activities 'generally are prohibited' by §10(b) would raise questions whether either civil or criminal defendants would be given fair notice that they have engaged in illegal activity"). In part, the Court seemed influenced by the fact that the Chiarella case was apparently the first in which criminal liability had been imposed upon a purchaser of securities under Section 10(b) of the Exchange Act for failure to disclose material, nonpublic information. Id.

well beyond the case at hand.[27] In Dirks the Court, in addressing the standards to which corporate insiders who communicate material, nonpublic corporate information will be held, set forth what is often referred to as the "personal benefit" test.[28]

At present, under the rule of Dirks, in order to bring a successful prosecution based on the tipping of inside information, the government must show: (a) that the tipper communicated the information in order to receive a personal benefit of some sort or (b) that the tippee was bound by an independent duty to speak before trading on the basis of the information communicated to him. The first of these two requirements has led to detailed and intrusive allegations regarding personal relationships, in Commission complaints, to support a finding of the requisite personal benefit;[29] the second requirement has led the government on an often attenuated and occasionally fruitless search for independent duties to speak before trading on the basis of tipped inside information.[30]

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[27] The Supreme Court's decision in Dirks v. Securities and Exchange Commission, 463 U.S. 646 (1983), underscores the adverse consequences of an effort to propound standards of conduct through enforcement actions. Dirks, a financial analyst employed by a broker-dealer firm, learned of an issuer's fraud from a former employee of the issuer. Dirks undertook an ultimately unsuccessful effort to interest the Commission and the Wall Street Journal in what he had learned. Thereafter, he advised his clients, including several large institutional clients, of the issuer's fraud, which led the clients to sell their holdings in the affected securities. The Supreme Court reversed a Commission enforcement action against Dirks, rejecting the agency's heretofore unarticulated claim that Rule 10b-5 forbade trading by a corporate outsider who was not bound by any specific duty to disclose his information or abstain from trading.

[28] In assessing the liability of those who receive material, nonpublic information, the Court announced that

> the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach [by the tippee]. Id. at 662.

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[29] See, e.g., Securities & Exchange Commission v. Thayer, [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,718 (S.D.N.Y. 1984) (allegations of "private personal relationship" set forth to support charge that tipper benefitted from his mistress/tippee's trades).

[30] See, e.g., United States v. Reed, 601 F. Supp. 685, 703-18 (S.D.N.Y.), rev'd in part, 773 F.2d 477 (2d Cir. 1985) (confidential relationship between father and son unsuccessfully alleged to show that the defendant son abused the confidential relationship by misappropriating information from his father); Securities and Exchange Commission v. Switzer, 550 F. Supp. 756, 766-767 (W.D. Okla. 1984)) (corporate outsider who overhears an insider discuss material, nonpublic information has no relationship with, and therefore owes no duty to, shareholders of insider's company).

In our opinion, the personal benefit test has no merit. We believe that the need for such a test should be addressed (and disposed of) by the Congress, following an appropriate public airing of the relevant considerations. This approach is far preferable to waiting for another potentially restrictive decision by the Supreme Court. The bill before you would eliminate the troublesome "personal benefit" test.

Having only recently granted the writ of *certiorari* in the *Winans* case, it is improbable that the Supreme Court will have heard oral arguments in the case and rendered its decision appreciably before mid-1988. Yet, insider trading is a serious problem *now*. As the government's insider trading investigations lead to continued revelations of misconduct, the need to restore and maintain public confidence in the fairness, honesty and integrity of the nation's capital markets increases.

Plainly, there is a need for Congress to act now to address the problem of insider trading. The present climate provides a unique opportunity to so act. This opportunity should not be permitted to pass without strengthening and clarifying existing law. It is especially important to assure that the popular perception of the commitment of Congress to this important issue is not jeopardized by inaction. It cannot be over-emphasized that the confidence of investors in the marketplace must be maintained.

The first step toward assuring investor confidence is to press forward with the aggressive enforcement of the federal securities laws. But, as with any such enforcement program, prosecutorial zeal must be tempered with fairness, and a fundamental requirement of fairness is that the elements of an offense be known in advance of the prosecution of people who are accused of that offense.

There has been no shortage of testimony in support of the proposition that it is unclear exactly what constitutes insider trading.[31] Thus, as we have pointed out above, it is time to face squarely the issue of defining the offense of insider trading with sufficient precision and specificity to put the public on notice as to the requirements of the law.

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[31] *See*, ABA Insider Trading Task Force Report; *see also*, *Hearing Before the Subcomm. on Securities of the Senate Banking, Housing and Urban Affairs Comm.*, 100th Cong., 1st Sess. (Feb. 24, 1987) (Statement of Harvey L. Pitt); *Hearing Before the Subcomm. on Telecommunications, Consumer Protection and Finance of the House Comm. on Energy and Commerce*, 99th Cong., 2d Sess. (June 18, 1986) (Statements of Harvey L. Pitt and George Ball); *Demand Rises for Law Defining Insider Trading to Provide More than a Gut Feeling as a Guide*, Wall St. J., Mar. 26, 1987; *Bigger SEC Budget, Clearer Definition of Insider Trading Backed by Senators*, Wall St. J., Feb. 25, 1987.

V. THE PROPOSED LEGISLATION

As a threshold matter, it is important to re-emphasize that the proposed Insider Trading Proscriptions Act of 1987 will enable the government to prosecute any case that is legitimately within its reach under current law. The Insider Trading Proscriptions Act will contain two primary operative subsections -- one that deals with wrongful trading and one that deals with wrongful tipping. These two basic provisions have been designed to reach every kind of trading and tipping case susceptible to legitimate prosecution under existing law, and to expand the law where appropriate.

The Insider Trading Proscriptions Act is structured to include the following seven subsections:

1. Congressional Findings -- Nowhere in the federal securities laws as they exist today is there an express statement of the Congress's reasons for prohibiting "insider trading." Indeed, a minority of commentators, including some eminent legal scholars and economists, have argued that no public purpose is served by such prohibitions, because market efficiency is promoted by allowing trading by insiders based on their informational advantages. Absence of an express

statement of policy has served to hamper both government prosecutors and the courts in developing strategies to eradicate illegal insider trading. To remedy this situation, subsection (a) of the Insider Trading Proscriptions Act has been drafted to state a clear congressional finding that insider trading is wrong and to articulate Congress's reasons for reaching that conclusion. It includes four Congressional findings as to why insider trading prohibitions are sound public policy:

a. the harm to the fairness, honesty and integrity of the nation's securities markets that flows from insider trading;

b. the need for a legislative proscription against insider trading to prevent or redress such harm;

c. the importance of maintaining the flow of information to the nation's securities markets; and

d. the need for clarity in the law, which need is served by specifically defining what constitutes the wrongful use or communication of material, nonpublic information.

2. Prohibition Against The Wrongful Use of Material, Nonpublic Information -- Subsection (b)(1) of the statute would accomplish the following three purposes:

   a. It would prohibit the use of material, nonpublic information to purchase or sell securities if the trading person knows (or is reckless in not knowing) that the information was wrongfully obtained or that the transaction would constitute a wrongful use of the information. This section defines the term "wrongful," in the context of a trading prohibition, to embrace any direct or indirect theft or misappropriation of information, or any use of information that is inconsistent with a fiduciary, contractual, employment, personal or other relationship of trust and confidence. Thus, the misappropriation theory that has been so critical to recent prosecutions is incorporated into the law formally, and, for the first time, defined in plain language. This provision is intended to prohibit the unfairness that results when an informational advantage has been wrongfully

obtained or abused, but does not reach legitimate informational advantages obtained, for example, by a hard-working analyst or investment manager. See proposed Section 16A(b)(1).

   b. It would create a statutory presumption that the trading of securities by one who possesses material, nonpublic information about such securities (or about the market for such securities) will in fact constitute the actual misuse of that information in connection with such transactions. See proposed Section 16A(b)(2).

   c. It also establishes that non-natural persons -- entities such as broker-dealer firms and banks with trust departments -- can rebut the presumption of use flowing from the possession of material, nonpublic information, if such a non-natural person is able to prove that the securities transactions in question were not influenced by the information and that the individuals effecting the trades (or causing the trades to be effected) did not know the material, nonpublic information. Thus, in the case of a multi-service financial firm, the possession in one department of material, nonpublic information concerning securities, and the purchase or sale of those securities by another department, will not give rise to liability if the firm can prove that the trade was not influenced by the information received. Such a provision will continue the strong incentive for multi-service financial firms to maintain effective "Chinese Wall" procedures.[32] See proposed Section 16A(b)(2).

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[32] This provision preserves the concept of a "Chinese Wall," by identifying as relevant to the non-natural person's burden of proof the implementation and maintenance of reasonable policies and procedures to prevent violations of the Act by individuals making investment decisions for the entity.

3. Prohibitions Against the Wrongful Communication of Material, Nonpublic Information -- The Act contains the following proposed operative proscriptions against tippers of material, nonpublic information:

   a. Subsection (c)(1) is a broad "anti-tipping" prohibition incorporating the same "wrongfulness" standard set forth in the trading prohibition, proposed Section 16A(b)(1). Subsection (c)(1) proscribes any direct or indirect communication of material, nonpublic information if the person making the communication knows (or is reckless in not knowing) that the communication would (and it then in fact does) lead to a trade in the securities that are the subject of the communication. As we mentioned earlier, this provision eliminates the need for the "personal benefit" analysis set forth by the Supreme Court in Dirks, while precluding liability for good faith communications made for a proper purpose.[33] Thus, the proposed legislation preserves the protections accorded by Dirks to securities analysts and the corporate officials to whom they turn for information, but removes from insider trading jurisprudence the vague and unworkable "personal benefit" test.

b. Proposed subsection (c)(2) contains a more specific "anti-tipping" prohibition, designed to address the widely-held perception that so-called corporate raiders tip inside information regarding their possible or actual takeover plans to third parties, to put a company "into play." This subsection expressly prohibits persons who are planning to buy or sell a public company, its

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[33] It is implicit in this requirement of a proper purpose that a showing of scienter will be required to sustain an allegation of an improper purpose. The current judicial definition of scienter -- that is, a "mental state embracing intent to deceive, manipulate or defraud," Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193-194 n. 12 (1976) -- is not altered by this legislation, nor does this statute in any way modify the case law that holds recklessness to constitute scienter. Further, it is anticipated that the courts will continue to develop the contours of the definition of scienter, as they have prior to this legislation.

assets or a material block of its securities, from communicating information, for the purpose of influencing securities transactions, about their plans to any other person who is not either part, or being solicited to become part, of the communicating person's transacting "group," as that term is defined in Section 13(d)(3) of the Exchange Act.[34]

This provision is designed to inhibit the abuse of material, nonpublic information concerning changes in corporate control. As with the tipping prohibition in proposed Section 16A(c)(1), proposed Section 16A(c)(2) would require as a predicate for the tipper's liability that the tippee actually purchase or sell a security while in possession of the tipped information.

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[34] Section 13(d)(3) of the Exchange Act, 15 U.S.C. § 78m (d)(3)(1982), provides that:

> When two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding or disposing of securities of an issuer, such syndicate or group shall be deemed a person for the purpose of this Section.

4. Derivative Liability -- Proposed subsection (d) of the Insider Trading Proscriptions Act would create a closely circumscribed "safe harbor" for persons who employ or control individuals who violate the prohibitions of the Act, by dictating that employers and controlling persons shall not be derivatively liable for such violations of employees or controlled persons based solely upon their employment or control of the individual who has committed the violation.

It must be noted that this "safe harbor" is extremely narrow: If the employer or controlling person in any way profited from, or otherwise participated in, the violation -- for example, even if only to the extent of receiving a portion of the commissions generated by a tainted securities transaction -- this safe harbor would be unavailable and the more stringent requirements discussed above in connection with proposed Section 16A(b)(2), would have to be satisfied in order to avoid secondary liability. Essentially, the new provision would protect employers from liability in the cases when the employee is off on a frolic of his own which is neither condoned by, nor of economic benefit to, the employer.

5. Commission Rulemaking Authority -- Because of the precision with which the proposed Insider Trading Proscriptions Act has been drafted, the Commissions's general rulemaking power, set forth in Section 23 of the Exchange Act,[35] is inapposite. Proposed subsection (e) of the Insider Trading Proscriptions Act would, therefore, delegate to the Commission two specific types of rulemaking authority. First, the Commission would be empowered to implement the provisions of the Insider Trading Proscriptions Act, consistent with the statement of Congressional findings set forth in Section 16A (a) of the Act. Second, the Commission would be authorized to exempt from the reach of the Act any transactions, persons and classes of transactions and persons, where the Commission finds that such an exemption is consistent with the intended reach of the Act.

This specific provision for rulemaking authority is intended to guide the Commission's exercise of that authority along the path set forth in the statements of purpose contained in the Congressional findings, thereby achieving a balance between unbridled rulemaking authority, which might impede the continued liquidity of the capital markets, and unduly circumscribed rulemaking authority, which might disable the Commission from addressing clear abuses.

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[35] 15 U.S.C. § 78w (1982).

6. Private Rights of Action -- Proposed subsection (f) of the Act expressly would provide a private right of action for persons who are injured by a violation of the proscriptions contained in the Act. This provision would achieve two goals: First, it would assure that those persons whom the Insider Trading Proscriptions Act is designed to protect possess a mechanism by which they could invoke that protection. Second, it would recognize that private, as well as governmental, enforcement of the Act is necessary to vindicate the remedial purposes of the legislation. Absent such a provision, the Courts would have to guess at whether Congress intended an implied private right of action. In a statute which addresses the subject of insider trading in a comprehensive fashion, we see no reason to leave a decision on private rights of action up in the air for future judicial resolution, particularly in light of the more recent judicial hostility to implied rights of action.[36]

The provision of an express private right of action would effectively "overrule" the guidelines set forth by the Court of Appeals in Moss v. Morgan Stanley Inc. for ascertaining the class of persons in whom such a right might repose.[37] The result of that case was to deprive of any federal remedy those persons best able to articulate an injury resulting from insider trading -- that is, the readily identifiable class of persons who traded contemporaneously with the insider trader, but who did not possess that person's informational advantage. The approach of proposed Section 16A(f) abandons the fiduciary duty analysis, as set forth by the Supreme Court in Chiarella and Dirks, as to a private right of action. Having departed from such an analysis in the substantive prohibitions of the Act, a decisional principle that predicates the standing of a private plaintiff upon that analysis is not required and would be inappropriate.

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[36] See, e.g., Pitt, Standing to Sue under the Williams Act after Chris-Craft: A Leaky Ship on Troubled Waters, 34 Bus. Law 117, 120, 162 (1978), cited with approval in, Cannon v. University of Chicago, 441 U.S. 677, 699 n. 24 (1979).

[37] 719 F.2d 5 (2d Cir. 1983) cert. denied, 465 U.S. 1025 (1984). The Court of Appeals in Moss refused to allow plaintiffs who traded contemporaneously with the defendant-insider trader to pursue their claim, based on the duty analysis that emerged from Chiarella and Dirks. The court examined the relationships and juxtaposition of the parties and found that, since defendants were employed by the investment banker to the bidder in the transaction in question, and plaintiffs were shareholders of the target corporation, the defendants owed no fiduciary duty to the plaintiffs and, thus, were not bound by the "disclose or abstain" rule. As there was no duty to disclose, the court reasoned, there could be no violation of the federal securities laws based on an undisclosed informational advantage. Id. at 12-16.

The requirements of Section 16A(f) would, however, preserve the standing requirements articulated by the courts in Birnbaum v. Newport Steel Corp.[38] and Blue Ship Stamps v. Manor Drug Stores[39] -- that is, standing to assert a private right of action under

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[38] 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).

[39] 421 U.S. 723 (1975).

the Insider Trading Proscriptions Act would be limited to those persons who either bought or sold the affected securities in the same market as the insider trader. No cause of action would lie for a person who claims that he "refrained" from purchasing or selling securities during the period when the defendant was in the market. While the Act would provide very specifically for one particular type of private action, the statute would not preclude the implication of other forms of private claims alleging different types of injury flowing from a violation of the substantive prohibitions of the Act.

7. Exclusivity -- Proposed subsection (g) of the Act would dictate that the Insider Trading Proscriptions Act henceforth shall provide the sole mechanism and standards for insider trading actions brought under the federal securities laws. However, where elements other than an improper informational advantage are involved in a fraudulent or manipulative scheme, Sections 10(b) and 14(e) of the Exchange Act and any general antifraud rules thereunder, will remain unaffected and available as a basis for prosecution.

The Act would not pre-empt state law in this area, nor would it affect or supersede the provisions of the Racketeer Influenced and Corrupt Organizations statute ("RICO"),[40/] except to the extent that insider trading constitutes a predicate act under RICO, in which case the Insider Trading Proscriptions Act would provide the sole basis for determining whether such a predicate offense had been committed.

VI. RESOLVING THE AMBIGUITIES UNDER CURRENT LAW THROUGH THE APPLICATION OF THE INSIDER TRADING PROSCRIPTIONS ACT

Earlier, we identified a number of points at which the uncertainties in the current jurisprudence of insider trading emerge. We will now discuss the manner in which each of these issues would be resolved under the proposed Insider Trading Proscriptions Act.

- Whether the so-called misappropriation theory is an appropriate basis for insider trading liability

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[40/] 18 U.S.C. §§ 1961, *et seq.* (1982)

Section (b)(1) of the Insider Trading Proscriptions Act specifically would identify as wrongful the use of information that has been misappropriated. Thus, the proposed legislation would clearly legitimate the misappropriation theory as a cognizable basis for insider trading liability.

- If the misappropriation theory is an appropriate basis for insider trading liability, what breaches of duty will sustain a government charge of liability

Proposed subsection (b)(1) of the Act, in its definition of the term "wrongful," identifies the use of misappropriated information to trade securities, standing alone, as a sufficient basis for insider trading liability. There need not be any specific kind of duty-creating relationship alleged as a predicate because, once it has been shown that purloined information was used to trade securities, the breach is complete. In instances of other sorts of misuses of information, subsection (b)(1) of the proposed statute enumerates certain relationships, the breach of which would result from the use or the taking for personal use of material, nonpublic information. Thus, the misappropriation theory is clearly defined and is not limited solely by concepts of fiduciary duty.

- What actions and states of mind of tippers who do not trade, and tippees who do, are required to impose liability

A tipper who does not personally trade would be liable under the Act for the profits gained or losses avoided by his tippee, if it could be shown that the tipper communicated the information with scienter -- that is, wrongful intent or recklessness, as currently defined by the courts.[41] In this context, the tipper must be shown actually to know, or recklessly to have failed to know, that the tippee would thereafter trade the securities that were the subject of the tipped information. While it also would have to be shown that such a trade did in fact occur, the tippee need not be shown to have acted with scienter in order to find the tipper liable under proposed subsection (c)(1). This would be a departure from the post-Dirks analysis of tipper liability, which requires both some "personal benefit" to the tipper, and some knowledge of such benefit or independent breach of duty by the tippee, to be shown to support the existence of scienter.

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[41] See, supra, p. 33.

Under the provisions of proposed subsection (b)(1), a tippee who trades following a tip would be liable if he knows, or recklessly disregards the fact, that the information was wrongfully obtained by the tipper (that is, in breach of the tipper's duty to safeguard the confidentiality of the information), was wrongfully communicated to him by the tipper (again, in breach of the tipper's duty to protect the confidentiality of the information) or that the tippee's own use of the information for personal securities trading would be wrongful.

Thus, under the proposed Insider Trading Proscriptions Act, there could be no liability on the part of an inadvertent, or even a negligent, tippee. In order to sustain liability, a tippee's mental state would have to rise to the level of scienter.[42]

- When, and under what circumstances, will mere silence alone constitute a breach of duty

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[42] See, supra, p. 33.

If it is clear that a securities transaction would be wrongful under proposed subsection (b)(1), then the trading person would become subject to the traditional "disclose or abstain" rule;[43] at that juncture, a transaction in the affected securities without prior disclosure of the inside information would result in liability. However, the statute would not reach silence about material, nonpublic information that is not accompanied by wrongful trading or tipping, thus allowing corporations and corporate officers to remain silent about material developments for legitimate corporate purposes so long as they do not trade, tip others who trade or make misleading statements.

- To what extent will trading while in possession of inside information be deemed to be trading on the basis of that information and, thus, result in insider trading liability

Proposed subsection (b)(2) would create a presumption that trading a security while in possession of material, nonpublic

information concerning such security, or the market for such security, would constitute trading on the basis of the information and, consequently, would result in insider trading liability.

Proposed subsection (b)(2), however, includes a specific defense to the presumption for entities (but not for individuals), such as multi-faceted financial service firms, that possess material, nonpublic information in one department while another department, which is insulated from the information, trades the securities that are the subject of the information. If such an entity is able to prove that the trades were not influenced in any respect by the information, and that the persons effecting the trade (or causing it to be effected) did not know the information, then no presumption of use arises.

- When, and under what circumstances, will institutions that employ persons who engage in illegal insider trading clearly be liable for the wrongful acts of their employees.

The proposed Insider Trading Proscriptions Act distinguishes between two types of institutions that employ persons who violate the Act. They are: (a) the institution that neither profits from, nor otherwise participates in, the illegal activity and whose only nexus to such activity is the employment or control relationship; and (b) the institution that does either participate in, or profit from the illegal activities of its employee, such as by receiving a portion of the commissions generated by the tainted trades, or by virtue of the unlawful transactions being effected for or through the institution's proprietary account.

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[43] In the Matter of Cady, Roberts & Co., 40 S.E.C. 907 (1961).

In the former case, proposed subsection (d) of the Act provides that no such institution shall be derivatively liable for the illegal activities of an employee based solely on the employment relationship. Where, however, an institution either profited from, or otherwise participated in, its employee's illegal activities, under the Act the institution also would be liable for those trading activities.

- Whether, and on behalf of whom, a private right of action for injuries sustained as a result of insider trading exists

Subsection (f) of the proposed legislation would expressly create a private right of action for persons trading

contemporaneously with the violator, who are injured by the violation. Other classes of persons who have traded the affected securities and who assert that they have been injured by a violation of the Insider Trading Proscriptions Act may plead their claim; the courts are free to imply other forms of private rights of action beyond that which is specifically delineated in the Act.

- To what extent will persons who engage in illegal insider trading be held liable for civil damages (in addition to the disgorgement of ill-gotten gains at the behest of the Commission, and the imposition of treble civil penalties under the Insider Trading Sanctions Act of 1984)

A person who is adjudged to have breached the prohibitions of the Insider Trading Proscriptions Act would face a maximum financial sanction of four times his actual profit gained or loss avoided (representing disgorgement of the principal amount plus the treble civil penalty).[44] Should such a person later be held liable for damages in private litigation, any damages would be offset by, and recovered from, the amount, if any, disgorged by the individual pursuant to the related proceedings brought by the government.[45] The treble civil penalty provision of the Insider Trading Sanctions Act adopted in 1984, and the criminal penalties under the Exchange Act, remain in place and would be unaffected by the Insider Trading Proscriptions Act.

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[44] As is the case under existing law, the civil penalty remedy would remain available only to the government.

- What statute of limitations is applicable to any private right of action for alleged insider trading

Proposed subsection (f) of the Insider Trading Proscriptions Act expressly incorporates by reference the five-year limitation period set forth in the Insider Trading Sanctions Act as providing the applicable statute of limitations for any private action brought under the Insider Trading Proscriptions Act.

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[45] Under current law, the Commission has successfully persuaded the courts to imply a disgorgement remedy in insider trading cases, under the court's inherent equitable powers. 15 U.S.C. §78u (d) (Supp. II 1982). The proposed legislation would make it explicit that such authority resides in the courts to be granted as a matter of judicial discretion at the behest of the SEC.

- To what extent does the Commission have the authority to exempt certain transactions from the reach of any insider trading prohibition

Proposed subsection (e) of the Act would grant to the Commission rulemaking authority that specifically includes the authority to exempt by order any persons, transactions and classes of persons and transactions from the reach of the Insider Trading Proscriptions Act, if the Commission finds that such an exemption is within the intended scope and reach of the Act.

VII. CONCLUSION

The needs for clear Congressional findings on the evils of insider trading and a precise, plain-English definition of the offense of insider trading have been amply demonstrated. The proposed statute now before you is a comprehensive codification prepared in consultation with leading experts and widely circulated among interested persons, which we believe effectively addresses the present ambiguities in the law. It should provide a firm base for the government's enforcement program and a clear and fair warning to the securities markets, and to those who participate in them, as to what conduct is prohibited.

EXHIBIT 1

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EXHIBIT 2

HARVEY L. PITT

Harvey Pitt has, for the past nine years, been a partner in the Washington office of Fried, Frank, Harris, Shriver & Jacobson, a 350-attorney law firm, with additional offices in New York City, Los Angeles and London. Mr. Pitt serves as the Chairman of Fried, Frank's Washington Corporate Department, and Co-Chairman of Fried, Frank's Washington Office. He is the Chairman of the Subcommittee on SEC Practice and Enforcement of the American Bar Association's Committee on Federal Regulation of Securities, and Co-Chairman of the Subcommittee on State Takeover Laws of the American Bar Association's Committee on State Securities Regulation. Mr. Pitt is an Advisor to the American Law Institute's Project on Corporate Governance. Mr. Pitt serves as a member of the Executive Council of the Federal Bar Association, and is Co-Chairman of the Practising Law Institute's Annual Securities Regulation Institute, the Nation's oldest and most successful continuing legal education program devoted solely to the federal securities laws.

Prior to joining his law firm in 1978, Mr. Pitt served on the staff of the Securities and Exchange Commission for over a decade, during the last three years of which (from 1975 to 1978) he was the Commission's General Counsel, serving three chairmen under both Democratic and Republican Administrations.

Prior to that appointment, he served, among other things, as the Chief Counsel of the Commission's Division of Market Regulation, and as an Editor of the Commission's Institutional Investor Study. He was also the Executive Assistant to SEC Chairman Ray Garrett, Jr. from 1972 to 1973, and a Legal Assistant to former SEC Commissioner Francis M. Wheat from 1968 to 1969. From 1973 until 1975, Mr. Pitt was the principal SEC attorney responsible for the Commission's extensive participation in the legislation that ultimately became the Securities Act Amendments of 1975. In 1976 and 1977, Mr. Pitt was responsible for drafting the SEC's recommendations for legislation that ultimately became the Foreign Corrupt Practices Act of 1977.

Mr. Pitt was the Thomas O'Boyle Distinguished Practitioner at the University of Pennsylvania School of Law in 1984, and, for more than a decade, served as an adjunct professor on the law faculties of Georgetown and George Washington Universities. Mr. Pitt is the author of two law treatises scheduled to be published later this year -- Pitt on Insider Trading, and A Practical Primer on The Law of Financial Services -- as well as numerous articles on insider trading and other facets of the federal securities laws.

EXHIBIT 3

JOHN F. OLSON

Mr. Olson is a partner in the Washington office of Gibson, Dunn & Crutcher, a 650-attorney firm with additional offices in 15 other cities. He joined the firm in 1964 after graduating from Harvard Law School. Mr. Olson was one of the founders of the firm's Newport Beach office in 1967 and, in 1977, of the firm's Washington, D.C. office. He specializes in representation of business organizations as to corporate securities, corporate finance and acquisition matters and in international commercial transactions. He has led teams of the firm's lawyers in major public offering and acquisition matters and has acted as special counsel to advise special committees of boards of directors in takeover contests and in investigations of questionable payments and claimed unsound practices of financial institutions. He has also represented corporations, broker-dealer firms and individuals in defense of Securities and Exchange Commission and other governmental investigations.

From 1983 to 1985, Mr. Olson served as General Counsel of The District of Columbia Bar.

Mr. Olson chairs the Task Force on Regulation of Insider Trading and the Subcommittee on Civil Liabilities and Litigation of the American Bar Association's Committee on

Federal Regulation of Securities which has recently completed a comprehensive three year study of the treatment of insider trading under the federal securities laws. He served for a number of years as a member of the ABA Coordinating Group on Regulatory Reform (which coordinated the work of all ABA sections and committees on regulatory reform issues in Congress) and served for three years as Chairman of the ABA's Committee on Foreign Claims. He was a founding Trustee of the American College of Investment Counsel and is a member of the Executive Council of the Securities Committee of the Federal Bar Association.

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Senator RIEGLE. Well, I'm inclined at the moment to put the rest of your remarks in the record. We've got an excellent attendance and I think it shows the great importance of this issue and the seriousness with which the Senators here present take it, and I think I would like to in short order get into the question period. In fact, I'm even wondering—I'm inclined maybe to hold off myself. I don't know how you feel, Al.

Senator D'AMATO. Mr. Chairman, I am convinced after having worked and had the benefit of our counsel and staff that this law, if anything, will not create loopholes and will close down gaping loopholes that exist now due to the vagueries of court decisions. So I would pass by any of my opportunity to ask any questions because I think it's important that our colleagues have that opportunity to put forth those questions to these distinguished attorneys as it relates to their very legitimate concerns.

Senator RIEGLE. And I'll do the same and we will offer our questions at the end.

I'd like to then start with my colleague from Alabama, Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

STATUTORY PRESUMPTION

Mr. Pitt and Mr. Olson, I've been looking through some of your material and I'm familiar with when you testified before, before this committee. Would you elaborate a little bit for me some of the proposed legislation where it would create a statutory presumption that the trading of securities by one who possesses material and so forth—in other words, the burden of proof would then shift to the people who had it to explain it away and so forth?

Don't you have problems with this? This would be a criminal prosecution, is this not right?

Mr. PITT. Yes.

Senator SHELBY. And under the basic laws, as I understand it—and I'd like to hear what you say—the burden is always on the prosecution to prove and then the jury can infer certain things and the judge will instruct the jury, but to create a presumption of guilty is what you're really doing here, it would certainly bother me and could cause some real due process constitutional problems. I'd like to hear your elaboration on that. I know it would make it easy to prosecute and everybody would be guilty just about, but I'd like to hear your explanation of that. That would trouble me greatly.

Mr. PITT. Certainly, Senator. I think what Senator Shelby is referring to, let me just say, is that there are two basic substantive components of the statute. One is the wrongful use of information.

Senator SHELBY. Right.

Mr. PITT. The second is the wrongful tipping or communication. I might add, in response to the comments both of Senators Wirth and Proxmire, that current law is at its weakest on the latter part, that is the prohibitions for tipping of information where the Supreme Court has developed basically I believe unworkable tests and we can get to that.

Senator Shelby's question really relates to the first prohibition which basically says if somebody wrongfully uses or wrongfully obtains information and then trades on the basis of that information that person will be presumed to have used the information.

This was designed to respond to a very thorny question in the law and involved great deliberations and communications with SEC enforcement officials. The SEC would prefer an absolute prohibition, which I think would provide that anybody who has nonpublic information and trades violates the law, irrespective of whether they relied on the information.

However, they understood that from an institutional point of view, that was really not workable because institutions that perform multiple functions may be able to show that even though one part of the institution had information, the people who actually executed the trade were unaware of the information and really should not have been aware of the information because the firm had adopted sensible procedures, if you will.

So what we have done is provided not a shifting of the burden of proof, although certainly it is calculated in that, I think it is appropriate to look at it——

Senator SHELBY. You're saying a presumption. That's a real shift, isn't it?

Mr. PITT. Yes, it is.

Senator SHELBY. Well, go ahead, but you have really shifted the burden of proof because of presumption.

Mr. PITT. I think what we have really done in legal and constitutional terms, Senator, is we've provided a defense for institutions. What we've said is, if you have the information and you trade, you start out with the assumption that you violated the law. But you can defend yourself if you can show that basically the person who made the trade didn't know and the people who influenced the trade didn't know and that there were appropriate procedures that were in effect.

Senator SHELBY. Can you see, though, you're talking about flaws in legislation and everything and this would be the first thing that would be challenged and probably thrown out. I could just name a lot of lawyers who would love to tackle you on this.

Mr. PITT. Well, let me say this.

Mr. OLSON. The courts have been using the possession test in a number of cases and it has not been a——

Senator SHELBY. But they haven't given it a presumption, have they? Isn't that up to the jury to decide?

Mr. OLSON. They have gone beyond presumption and simply said possession is enough.

Senator SHELBY. Then, as a factual matter, it's up to the jury to decide all this.

Mr. OLSON. The problem with that is that when they do that, when they come to institutional cases, the possession test by itself doesn't work.

Senator SHELBY. You're making it easy—and I understand what you're trying to do is stop a lot of this, but at the same time you've got to balance all of this within the area of criminal law and due process clause.

Mr. **Pitt**. I think this does that for this reason. If the statute had simply read anyone who possesses inside information and buys that same stock violates the law, that would be perfectly constitutional and I believe that the criminal law does recognize presumptions and the like, juries get instructions all the time about what they may infer and what they may presume and under what sets of circumstances the Government proves its case.

What we've done here and I believe that at least the staff members of the Commission with whom we spoke thought this was an acceptable approach, we have created a defense for institutions. It is specifically written into the statute and I believe that it would not raise the very legitimate constitutional concerns you are referring to because we could have had an absolute prohibition, but that would not be good for our markets. So what we have tried to do is come up with a situation in which the entity that has the information clearly has the substantial burden of showing that they didn't rely on it.

Senator **Shelby**. I would differ with you on it and I would be interested if you could furnish some information to me regarding the development of this. My time has expired.

Senator **Riegle**. Let me just say this, we're going to try to move right along within time limits, so I would think you will have another chance to pursue this and I want you to have that chance. Senator Bond.

Senator **Bond**. Thank you, Mr. Chairman.

ANALYSIS OF CURRENT CASES

I was just thinking, it might be interesting and informative for us for you to analyze some of the current cases that are well known such as the *Levine*, the *Dirks*, the *Winans* case, how this proposed statute would apply in those cases. Would you mind going through that drill for us?

Mr. **Olson**. I'm always reluctant to talk about pending cases, particularly when I don't know the facts thoroughly, but——

Senator **Bond**. Let's assume some hypotheticals.

Mr. **Olson**. On the *Winans* case, for example, if we read the opinions and we assume the facts as asserted there, Mr. Winans would be caught by our statute without any question because he obtained the information in breach of a duty to his employer. In other words, this statute would codify the position the Government has argued in the *Winans* case in which the two majority judges in the second circuit found a sufficient theory. So he would go to jail.

Senator **Bond**. You would still have to have some kind of breach of duty and there was a real question as to whether in that case he had been advised of the corporate policy.

Mr. **Olson**. Senator Bond, there are always going to be questions of fact about whether a duty was breached, but the statute is written in broad and expansive terms and simply says that if you misappropriate the information or if you obtain or use it in breach of a contractual, employment, personal, fiduciary or other relationship of trust or confidence, then that's enough.

Now obviously in each case there's going to have to be a factual determination as to whether there was such a relationship, but the statute is very broad. It's every bit as broad as any court has stated that theory.

Senator **Bond**. Well, take it one step further. If it has to be a breach of a corporate policy, assume there was a widely read newsletter which did not have any policy and which in fact told its writers and editors, "We're not going to pay you for this, but you write about stocks and if you want to profit from the moves you make in the market, go ahead." Would that then escape?

Mr. **Olson**. That would not escape for several reasons. First of all, I don't know whether such a hypothetical is possible. Why would anybody buy a publication of that kind? But assuming that it is——

Senator **Bond**. Assume that they don't know that it's that kind of——

Mr. **Olson**. That conduct might not only be reached by this statute but it would be reached as a market manipulation or scalping exercise under 10(b)(5), and this statute, although it is exclusive with respect to insider trading and tipping, does not in any way affect the ability of the Commission and the prosecutors to use the broad concepts of section 10(b) and rule 10(b)(5) to go after things like scalping.

Mr. **Pitt**. I do think it's important to distinguish, Senator, that one improvement over the current law is that if you look at the definition of wrongful, the misappropriation standard to which John referred a moment ago, is separate from the breach of duty and one of the problems the Government has had has been creating duties for people to breach.

What we are talking about is a statute that basically talks about, in effect, the theft of information, information that may have been available for one purpose, converted to another purpose for personal gain, and that would violate this provision of the law.

So I believe that at least as to the cases you have discussed, *Winans,* based on the facts, I believe would be caught, and it is our view that no case that the Government could legitimately bring today currently under current law would be foreclosed, curtailed, or in any way impeded under this proposal. But there would be cases under this proposal that the Government will be able to bring that they could not bring or at least bring with assurance under current law.

Senator **Bond**. How about a hypothetical like the *Dirks* case?

Mr. **Olson**. In the *Dirks* case, if it is in fact the Dirks case, probably Mr. Dirks would go free and he probably ought to because you remember what the court concluded in *Dirks* was that basically Mr. Dirks was performing a public service. He obtained information from a former employee of Equity Funding, a corporation which was engaged in massive fraud. He tried to get the Wall Street Journal interested in that information and they didn't think it had any support and they were unwilling to run the story. He told his clients about it. His clients sold out. Ultimately it turned out that the information he got from the former employee was correct and the stock fell dramatically. And the court looking at that said, "Where did Mr. Dirks go wrong?" The Commission had argued he went wrong because he told his clients and he didn't tell the world.

We don't impose an obligation of telling the world on the Mr. Dirks. We think analysts have a legitimate function in the market. As long as they don't steal information; and as long as they don't receive information which they know, or are reckless in not knowing, is given to them in breach of a relationship of a trust or confidence, they are free to convey it to their clients and to trade on it. And that is in part the answer to some of the arguments that Professor Manne is going to give you shortly.

We do believe in market efficiency and we do believe that analysts ought to be free to analyze. Mr. Dirks didn't break the law because he didn't steal the information he had.

Senator **Bond**. Thank you, gentlemen.

Thank you, Mr. Chairman.

Senator **Riegle**. Thank you, Senator Bond.

Senator Wirth.

Senator **Wirth**. Thank you very much, Mr. Chairman.

Gentlemen, again, thank you for your very good testimony.

Let me see if I understand what it is we are trying to do with this legislation. It seems as I have been listening to you and reading your testimony and with some background in the area, it seems to me we're looking at four things.

PURPOSES OF LEGISLATION

One, giving the SEC greater authority—rulemaking authority. Second, articulating—and these are your words, Mr. Pitt—articulating Congress' point of view on insider trading. Third, focusing on the wrongful communication of information or tipping. And fourth, attempting to define insider trading.

Those are the four basic purposes of this legislation?

Mr. **Pitt**. Well, the only one that I guess I would take some slight comment on is the first one, namely giving the SEC greater rulemaking authority.

The SEC would be given particularized rulemaking power here to enable it to deal, in response to Senator Riegle's question earlier, with new and unforeseen devices, but it would be tailored to what Congress tells the SEC what it believes the problems with insider trading are.

Senator **Wirth**. Then let's start with that. Has the SEC told us that they feel that they need greater authority in this area?

Mr. **Pitt**. I can tell you from my experience there that they wouldn't be likely to for fear that it would impede them in the very next case they would bring.

Senator **Wirth**. Why is that? Is that because they might feel that what we told them is a definition of what they could do might not be broad enough and they might want to reach to some new circumstances?

Mr. **Pitt**. No prosecutor likes to start by saying that the present law restricts them in any way or makes it difficult for them to go after wrongful conduct for fear that the next time that they bring a case their own remarks will jump up and bite them.

I succumbed to that when I was there and I know that that's an occupational hazard.

Senator WIRTH. Well, that's the whole tangle that we're then in, isn't that right? I mean, by saying that the Congress says to them specifically, "Thou shalt not do the following one, two, three, four, five," if we say that in 1987, by 1989 or 1991 there may be items nine, ten and eleven that we never imagined and then we have the SEC lawyers coming in saying, "Hey, we couldn't do anything about it because Congress was so explicit here guys are getting away with this over here."

Mr. PITT. That's the issue, but I don't think this does that.

Senator WIRTH. Well, I guess we're going to hear from the SEC on that and hear from them whether or not they believe that they have the authority to issue new rules.

Do they believe they have that authority now?

Mr. PITT. I don't know particularly because of the language of *Chiarella* and *Dirks* whatever the SEC might assert. We're trying to look at it a little dispassionately. I would say that their authority has been severely cut back because of those Supreme Court decisions. In particular, *Chiarella* made it clear that——

Senator WIRTH. We can get to that, but we have a limited amount of time and I appreciate that. But that it seems to me is a crucial question to ask.

Mr. OLSON. If they were going to write a tipping rule now, would they have to write the personal benefit test into it?

Senator WIRTH. Leaving tipping aside——

Mr. OLSON. Because of *Dirks?*

Senator WIRTH. Leaving tipping aside for a second as a separate issue, just the SEC's ability to write rules overall, do they feel they need more authority? That seems to me, Mr. Chairman, is the question we want to ask.

The second area that you mentioned, Mr. Pitt, in your opening remarks is that it is important in the law to—again to use your words as I've written them down—articulate Congress' point of view on insider trading and that that is essential to have Congress more on the record on the fact that we think insider trading is not a good thing, is that right?

Mr. PITT. Legislatively on the record, yes.

Senator WIRTH. Now is that not done in all of the debate on the floor of the Senate in 1984 when the Insider Trading Law was passed and all the record of that legislation and the same thing when that was going through the House? Is that not adequate to this task?

Mr. PITT. It certainly should be a source of comfort to the Members of the Congress, but in terms of its legislative impact in the Supreme Court it would be of no utility whatsoever because the Insider Trading Sanctions Act didn't deal with this problem and it doesn't address the problems of Chiarella or Dirks.

Senator WIRTH. But we made very clear Congress' intent and purpose on insider trading, didn't it, that the Congress was saying—I mean, I have no doubt about that whatsoever in all those deliberations. What you're saying is we ought to write some of that broader intent and purpose into the law?

Mr. PITT. Senator, let me make one observation, at the risk of extending this, because you made a comment in your opening remarks about the flexible and remedial legislation, which was a phrase I used to cite in all the briefs I wrote for the SEC. That language was terrific up until 1975 and the Supreme Court, starting in 1975, has taken what I would characterize as a more rigid construction approach to the language of statutes, and I believe what the Supreme Court has said to this Congress and this committee is, "If you think it and if you believe it, put it in the statute." If it's said on the floor of Congress and if it's said in debates, if it's said even in reports, it doesn't count unless the language of the statute embodies what Congress believes.

Senator **Wirth**. Mr. Chairman, my time has expired. Just in summary, it seems to me the points made here are, first, does the SEC need greater rulemaking authority? Do they feel they have to have it or not in this area? And this gets really to the nub of the question of giving them greater rulemaking authority do we constrain them or not?

Second, articulate our point of view on insider trading, which I don't think anybody has any problem with doing that. Let's do that in the statute if that is an imperative.

And the third area we did not get into which I am sure we will have a chance to is the whole issue of tipping and the wrongful communication of information which is not addressed elsewhere and it seems to me if we got into those three areas we could certainly do the second one without any problem and the third I gather there isn't a great deal of debate about. So we're back to how much rulemaking authority does the SEC feel that it needs. I'd like to hear from them on that.

Mr. **Pitt**. I don't think it's a question of—you posed it that way and I understand the articulation, but I don't think it's really a question of how much rulemaking authority the SEC needs.

I think the question you need to ask the SEC is not whether they think they need more or whether they believe that in *Winans,* but they should say though that they believe the U.S. attorneys will win *Winans.* What I think is the question that should be posed to the SEC by this subcommittee is, would this legislation provide greater clarity and assistance both to prosecution and people who need to know what the law is, and would it in any way hamper legitimate enforcement efforts?

If the answers to those questions come back as I believe they would, then I think this committee will have some degree of comfort that it has not done anything to impede the fair enforcement of laws that I believe this committee stands behind.

Senator **Wirth**. Thank you, Mr. Chairman.

Senator **Riegle**. Thank you, Senator Wirth.

Senator Sasser.

Senator **Sasser**. Gentlemen, suppose the Supreme Court should rule in the *Winans* case in such a way that it actually clarifies the definition of insider trading and builds on what's been good in the past in judicial pronouncements on this whole subject. Would it be worthwhile for us to wait and see what the Court will do in the *Winans* case or what is your view on that?

Mr. **Olson**. The short answer to that, Senator Sasser, is we would be amazed. I think that the likelihood of that is remote for several reasons. First of all, the Supreme Court has not in its past cases in this area been very clear. Second, views on the Court have diverged as to exactly what the appropriate touchstones are in this area and, therefore, you're likely to get several opinions. Third and perhaps most important, the facts in *Winans* are rather special. They don't, for example, the way the case has been posed to the Supreme Court, raise the tipping issue. Although tipping occurred in *Winans*, that's not the question before the Court. So there will be no clarification of the confusion created in *Dirks* as to what the personal benefit test means and what is a personal benefit and when is a tippee liable and so forth.

So even if the Supreme Court resoundingly affirms the second circuit, there are going to be critical areas of ambiguity that are not going to be dealt with.

Mr. PITT. I also think you will lose a certain amount of momentum. If the case were to come out adversely to the Government, as I think most observers think, I believe it becomes far more difficult to draft intelligent legislation and I also think the point John made in his opening remarks, that is that all the while the ambiguities in the law remain, suggests that this is a good time for the Congress to act.

Senator SASSER. Well, gentlemen, this committee has been wrestling or will be wrestling further in the future with the whole problem of corporate takeovers and much insider trading appears to have taken place during the course of some of these corporate takeovers.

EFFECTS OF THIS BILL ON SEC ENFORCEMENT

Now how would this bill, if enacted, enable the SEC to better prosecute or find insider trading violations or other violations involved in takeovers? I think the sharing of inside information has helped put a company in play and has facilitated takeovers. That seems to be generally conceded.

Would this bill be of any assistance in curbing abuses in that area and, if so, how?

Mr. PITT. Yes. If I may refer the subcommittee's attention specifically to subsection c(2) of the legislation, which I might add was a provision that was suggested to us informally by members of the SEC staff and received a great deal of time and attention, it would basically deal with a problem that the SEC believes to be difficult, which is the corporate raiders or others seeking to put companies in play, tip information to third parties in the hopes of creating an active marketplace. This provision would for the first time make that conduct illegal if the standards of the provision were met.

I might add, under current law that conduct is in all likelihood not illegal and the Government would have a great deal of difficulty in prosecuting it.

What this would say is, unless there is a good faith reason, a bona fide reason for communicating information or the persons who receive the communication were effectively part of a reporting group with the person who's going to make the bid, that the communication and then subsequent trading on the basis of the communication violate this statute and the person who tips violates the law.

Mr. OLSON. As Harvey said, Senator Sasser, this is one place where we go beyond the misappropriation theory and go beyond present section 13(d) and really offer new law to clarify an area which has been of concern to the Commission, and in this respect the statute would be a significant advance over the current state of the law.

I appreciate your calling it to the subcommittee's attention.

Senator SASSER. Gentlemen, I thank you. Thank you, Mr. Chairman.

Senator RIEGLE. Thank you, Senator Sasser.

Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Mr. Pitt, You argue that we need to define insider trading because the Supreme Court has rejected the SEC's cases on two occasions. But in one of these cases, *Dirks,* Mr. Olson says the SEC probably should have lost.

Now I agree with Mr. Olson. Dirks was merely carrying out his duty as a securities analyst to protect his client. He turned the information over to the SEC, told the Wall Street Journal, and then he told his client, having made it about as public as he could under the circumstances.

Why is this case relevant to why we need new law?

RELEVANCY OF DIRKS CASE

Mr. PITT. It's relevant, Senator, because in the course of that, the *Dirks* case articulated a variety of standards, including the much maligned and appropriately so personal benefit test.

What Dirks did was extend Chiarella and while it allowed Dirks to go free it did so, we would argue, for reasons that should prove ultimately unacceptable to this committee. That is to say, because it articulates, along with Chiarella, standards of law that unduly circumscribe what we think Congress intends to prohibit in the area of insider trading. That's why we think *Dirks* is particularly relevant and it's an example of how, even when the Supreme Court reaches a result to which this committee might agree, as could happen in the *Winans* case, some of the rationale runs counter to what we think an effective approach to this problem would be.

Senator PROXMIRE. You see, I'm puzzled again because I'm told that the problem in the *Chiarella* case was not the law but the way the case was presented to the trial court. Now if that's correct, then there is no compelling evidence that the Supreme Court decisions have weakened the ability of the SEC to go after insider trading.

Mr. OLSON. Well, the problem was that the law was so unclear that the prosecutor didn't know what to argue before the Court. And the Court said, "Ha, ha, you picked the wrong theory."

Mr. PITT. Well, let me say one other thing, Senator, on that because I think that's an important point. The fact is that it wasn't so much that the Government argued the wrong theory. It was that the Supreme Court said that this Congress had never articulated a notion that insider trading was bad for the marketplace. As a result, a person like Chiarella could not be prosecuted if his wrong was a wrong against the market.

This statute, I might add, and the congressional findings would change that. Now the Government came up with an alternative theory to deal with the defense contentions and there was division on the Supreme Court as to whether the Government had properly argued it or not, but I can assure you the Government would tell you that they think they did allege the misappropriation theory in the case.

The fact is, the Supreme Court said they didn't and came up with a result in which somebody who clearly engaged in reprehensible conduct was allowed to go free.

Senator PROXMIRE. Now you have two cases here. I'm trying to get a better understanding of the precise effect of this proposed definition of insider trading.

Can you give an example of a case that could not be successfully prosecuted under current law that could be so prosecuted under the proposed law? And are there any kinds of cases that could be prosecuted under current law that could not be prosecuted under the proposed law?

Mr. OLSON. Certainly *Chiarella* and *Winans* are both cases that could be clearly successfully prosecuted under the proposed law and where the state of the law at present is very much in confusion.

Mr. PITT. I guess another one is one some of us saw the movie the "Big Chill" and the opening scene shows the president of the company running with his friend and saying, "I shouldn't be telling you this but my company is going to be taken over and I know you're an extremist." I think under current law there is a significant question, assuming nobody perjured themselves, as to whether any governmental prosecution could be obtained because of the personal benefit test.

We have eliminated the personal benefit test from this proposed legislation and the result of that would be that I believe a successful prosecution would clearly lie.

In addition, I think John's point should be reemphasized. No case under current law that could legitimately be brought by the Government would be foreclosed under our provision. I think we are quite confident that we have caught every case that the Government legitimately could prosecute.

Senator PROXMIRE. Take the *Winans* case. You raised that as a third case. One of the major reasons advanced for this legislation is that current law is inadequate to reach insider trading by those who are not corporate officials. For example, it's argued that the Government's case against Wall Street Journal reporter Winans was possible only because the Journal happened to have an employee code of ethics which Winans allegedly violated. Now even that approach may be overturned by the Supreme Court.

Suppose the Journal did not have an employee code of conduct and you had been assigned to prosecute the *Winans* case under the proposed law. Can you describe in some detail exactly the theory you would use to prosecute the case?

Mr. PITT. Yes. I think I would start by saying—and I'm now referring to section b(1) of the proposed legislation—that it could be shown that Winans under that situation would at a minimum have engaged either in theft, conversion or misappropriation of the information or would otherwise have breached a relationship of trust and confidence with the Journal. So I think there are four or five vehicles for the prosecution of Winans under the proposed legislation and I reiterate that I do not believe under existing law the Government will be successful, or largely successful, in its prosecution of Mr. Winans.

Senator PROXMIRE. The code of ethics wouldn't be necessary under the proposed legislation?

Mr. PITT. The code of ethics would help, but its fortuity would be irrelevant under the new legislation.

Mr. OLSON. The nature of the employment relationship and its normal expectations of confidentiality would be sufficient, in my view, even if there were not a printed code of ethics.

Senator PROXMIRE. Thank you, Mr. Chairman. My time is up.

Senator RIEGLE. Thank you, Senator Proxmire.

I know Senator Shelby has another matter he wanted to raise.

Senator SHELBY. I will be brief, Mr. Chairman.

Senator RIEGLE. Fine. Senator Shelby.

PREVENT HOSTILE TAKEOVERS OR INSIDER TRADING?

Senator SHELBY. Other prominent people, including some witnesses who will testify before this committee today, have suggested and said outright that this proposed legislation confirms some of their feelings that it's the hostile takeover legislation that you're trying to pass here—in other words, you're trying to prevent—and not insider trading. In other words, the real target is hostile takeovers, not insider trading. And by pushing this bill, if it were to become law, that then you're going to create a real easy seat for a lot of corporate management not competent and not responsive to stockholders and so forth.

How do you respond to that?

Mr. PITT. Well, I start by saying it's simply untrue and misperceives——

Senator SHELBY. You know it's out there, though?

Mr. PITT. I saw the written statement this morning and I know it's out there and I want to stress that it is, in my view, not correct and I believe that this committee has before it, sponsored by Senators Proxmire and Riegle, some appropriate legislation that would deal with very difficult questions about tender offers.

This legislation deals with the problem of unfairness in our markets and trading by people who have unfair and wrongful informational advantages. That's all it deals with and it will include tender offer situations, but tender offers did not motivate this legislation and I don't believe that in any way, shape or form this legislation can be said to have any impact whatsoever on the tender offer process.

Mr. OLSON. The only way, Senator Shelby, that one could say that it affects negatively the tender offer process is if you believe that it's a good idea to make tender offers and so much so that cheating, lying, and stealing is OK to effect a tender offer. And we just don't subscribe to that.

Mr. **Pitt**. I do want to add, if I may, one other point and I will say this because one of my major preoccupations is, as a corporate lawyer, to work on tender offers.

This bill actually will enhance tender offers. One of the things that hurts tender offers is advanced leakage of information where the target has a good idea of who may be bidding for it and can start to deal with that particular person. By cutting down on the misuse of this information which is often very instrumental in helping a target identify who the bidder is, I think this may actually have a positive effect on tender offers.

Senator **Shelby**. Have either one of you gentlemen represented people involved in hostile takeovers?

Mr. **Olson**. I certainly have, and on both sides. I'm happy to be employed by anybody who wants to pay the fee.

Senator **Shelby**. Isn't it a fact, though, that a lot——

Mr. **Olson**. As long as it's not a conflict.

Senator **Shelby**. As long as it's not a conflict, and not inside, right?

Mr. **Olson**. Right.

Senator **Shelby**. Isn't it a basic fact, though, that a lot of the shareholders in America have profited by these hostile takeovers—you know, the marketplace? I'm not thinking so much about insider trading. I'm talking about shareholders.

Mr. **Pitt**. I know what you're saying and I think there are situations in which persons recognize—I know those who have a view of the efficient market will say that that's never so, that the market always reflects the value of a company. I don't share that view.

Senator **Shelby**. There are a lot of sleeping companies?

Mr. **Pitt**. There are some sleepy companies and there are shareholders who profit enormously and I have represented bidders who have acquired companies in that situation. But I've also been involved in situations from the defense side where companies are far more aware of their potential, and what you're talking about is short-term gain versus long-term maximization of profits, and I guess my view is the problem isn't as simple as saying because somebody walks in and offers a premium for stock that is of benefit to shareholders. And I say that for this reason. Even representing bidders, I have never known a bidder who's willing to pay more than the company is worth and I've always known bidders who try to pay less than what they think it's worth.

Senator **Shelby**. Well, that's the market, isn't it?

Mr. **Olson**. I must say you have very skillfully drawn my colleague here into a debate on another piece of legislation. I want to underline the fact that, though I generally subscribe to Mr. Pitt's views, this legislation, in my view, has nothing to do with tender offers and it's really neutral as to whether tender offers are good or bad.

Senator **Shelby**. Thank you, Mr. Chairman.

Senator **Riegle**. Thank you, both. I'm just going to ask a couple of items.

With respect to corporate officers, how does the legislation as you see it, affect the communications between corporate officers and financial analysts?

Mr. PITT. I think, in sum, it protects those communications because by introducing a wrongful standard into the process and by using a question of knowing or reckless in not knowing standard, we have combined with the congressional finding, which I think is the third finding about the free flow of information, put Congress squarely behind the communications that corporate officers need to have—legitimate communications with analysts and others, and get that information out into the marketplace while prohibiting the abusive practices that I think we have observed in some recent cases.

Senator RIEGLE. Let me ask you also, what are the potential damages to a firm or to an individual under this legislation and what are the potential damages under the existing law?

Mr. OLSON. Are you talking about the amount of damage or the penalties—the penalties, of course, are many and varied and they range from the civil penalties in the Insider Trading Sanctions Act to the criminal penalties that are in the Securities Exchange Act of 1934 and so forth.

But I think that perhaps what you're really driving at is what are the burdens that are going to be placed on institutions by this statute as opposed to existing law. This statute I think offers both benefits and burdens for institutions. The chief benefit is clarification, which is a great advantage in conducting their affairs. The burden is that they are going to have to carry—and this is Senator Shelby's concern—the burden of showing that there was not in fact the leakage of information which caused or influenced the trade. And that's going to be a burden which is not expressly placed on them by existing law, although one might read the case law as placing that burden. I don't know whether I've responded to your question or not, Senator Riegle.

Senator RIEGLE. You've been very helpful. Did you want to add something?

Mr. PITT. No.

Senator D'AMATO. Mr. Chairman, I have a question as it relates to misappropriation and I'd like to submit it for the record because it seems to me that some of our colleagues' concerns could be answered if we got into that and that people are placed in greater jeopardy as it relates to the law now and that there will be some clarity brought, but I would like to submit that for the record and if you could possibly get back to us on that.

Mr. OLSON. Certainly, Senator.

Senator D'AMATO. Senator Shelby when I left I had been raising that question and I'd like to follow through on it, but in the interest of time I'm wondering if we couldn't do it in writing.

Mr. PITT. Can I just say one thing on that point, if I might, and I won't go into a lengthy answer on that. I do think that any concerns about that should be heightened under the present state of the law where the Government is free to allege anything constitutes misappropriation, and the courts are free to find that either anything or nothing constitutes misappropriation.

This way, Congress will have control over the process which is where we think it rightfully belongs.

Senator SHELBY. If my colleague would yield——

Senator D'AMATO. Yes.

Senator SHELBY. My concern is, as both of the panelists have surmised here, is the burden of proof in the criminal case what you would create statutorially here and I would be interested in seeing what you send me and other members of the committee regarding this because just reading this at first hand it would bother me greatly and I'd like to hear from other people and I'm sure I will, that deal in constitutional questions.

Mr. PITT. We can submit something for the record that addresses those concerns as well as the misappropriation.

Senator SHELBY. Thank you.

[The following was subsequently submitted for the record:]

FRIED, FRANK, HARRIS, SHRIVER & JACOBSON
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

TO: The Securities Subcommittee of the United States Senate Committee on Banking, Housing & Urban Affairs

FROM: Harvey L. Pitt

RE: Insider Trading Proscriptions Act of 1987

DATE: July 13, 1987

Background

On June 17, 1987, the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs received testimony regarding S. 1380, The Insider Trading Proscriptions Act of 1987 (the "Act"). A copy of the Act is attached as Exhibit A to this Memorandum. During my testimony as chairperson of the committee of securities practioners that drafted the Act, Senator Shelby inquired whether the use of a presumption in the Act would raise constitutional questions under circumstances in which a criminal conviction relies upon the presumption. I have prepared this Memorandum in response to Senator Shelby's inquiry.

As I mentioned during my testimony, I believe that the Act as drafted would be upheld as constitutional and does not inhibit the defendant's right to a fair trial. The Act does not force the defendant to prove his innocence -- rather, it sets forth the elements of the crime of insider trading and then establishes an evidentiary presumption which satisfies the prosecution's burden of proof beyond reasonable doubt. The inference underlying the presumption is strong enough that the defendant's right to fundamental fairness required by the fifth amendment to the Constitution is not infringed.

The Presumption as Set Forth in the Act

As it is currently drafted, Section (b)(1) of the Act sets forth the following elements of the crime of insider trading:

- direct or indirect use
- of material, nonpublic information regarding a security
- in the purchase or sale of such security
- which information the defendant knows (or recklessly does not know) has been obtained wrongfully
- by the use of any of various means of interstate commerce

or

- wrongful use
- of material, nonpublic information regarding a security
- in the purchase or sale of such security
- by the use of any of various means of interstate commerce.

Section (b)(2) provides that if a person,

- ° while in possession
- ° of material, nonpublic information regarding a security (or the market therefor)
- ° purchases or sells that security

then the element of "direct or indirect use" of the information in connection with such purchase or sale "shall be presumed."

Section (b)(2) further provides that the presumption "shall be overcome," in the case of a non-natural person, when that person "sustains the burden of proving that:

> "(A) the purchase or sale of the security was not influenced by such material, nonpublic information; and
>
> "(B) the individual effecting the purchase or sale, or causing others to purchase or sell, on behalf of such person, did not know the material, nonpublic information."

The section then states that reasonable policies and procedures implemented and maintained by the person would be relevant to whether the person has sustained its burden of proof.

The Act thus establishes a circumstance when the prosecution need not introduce evidence to prove one element of the crime: if the defendant possessed the information and traded in the security, the fact-finder "shall presume" that the person actually used the information, and therefore the prosecution's burden of proving "direct or indirect use" would be satisfied.

Senator Shelby's question focuses upon whose burden it would be to prove the "direct or indirect use" element of the crime. As he correctly pointed out during the June 17 hearings, if the effect of the presumption were to require the defendant to bear the burden of proving his innocence as to the element of "direct or indirect use," then the presumption might face constitutional challenge under the due process clause of the fifth amendment.

I believe, as this Memorandum explains, that the presumption set forth in section (b)(2) of the Act does not have such an effect. Rather, the presumption is a statutory statement that if the prosecution establishes circumstantial evidence of defendants' trading while in possession of material, nonpublic information, then such evidence is sufficient to satisfy the prosecution's burden of proof that the defendant actually used the information. The inference from the fact of the defendant's trading while in possession of the information is strong enough to establish beyond a reasonable doubt that the defendant actually used the nonpublic information; therefore, the presumption alone is sufficient to prove this element of the crime.

The Law

The United States Supreme Court's most recent discussion of the validity of statutory presumptions is presented in *County Court of Ulster County v. Allen*, 422 U.S. 140 (1979). In that case, the Court upheld a presumption that presence of a firearm in an automobile was sufficient evidence to presume that all of the occupants of the automobile illegally possessed the firearm.

The Court focussed upon the jury instructions to determine whether the jury was told that the presumption was "mandatory" (which requires the trier of fact to *find* that one fact has been proven upon *actual* proof of another fact) or "permissive" (which allows but does not require the trier of fact to infer proof of one fact upon actual proof of another fact). In *Ulster*, the Supreme Court determined that the jury instructions allowed the jury to accept or reject the inference and to combine that inference with whatever other evidence the prosecution introduced regarding "illegal possession of a firearm." *Id*, 442 U.S. at 160-162. Thus, the Court held that the *Ulster* presumption was permissive and went on to uphold the statute.

In analyzing whether the statutory presumption was permissive or mandatory, the Court discussed mandatory presumptions at length in dictum. The Court explained that, if the jury instruction creates a "mandatory presumption" (a presumption which a jury must accept even if it is the sole evidence of that element of the offense, but which may be rebutted by the defendant who brings forth evidence to challenge the presumped connection between the facts and the inferred element of the crime), then the Court must examine the statute "on its face" to determine whether it is constitutional. Ulster, 442 U.S. at 159-160.

The Supreme Court has examined mandatory presumptions on several occasions. For example, in Turner v. United States, 396 U.S. 398 (1970), the Supreme Court upheld a mandatory presumption that possession of heroin was sufficient evidence to sustain beyond a reasonable doubt the inference that the defendant possessed illegally imported narcotics. The Court reasoned that it was virtually certain that the heroin was produced outside the United States because, although heroin conceivably could be produced in this country, "the overwhelming evidence" is that it almost never is. Turner, 396 U.S. at 415. Conversely, the Court overturned Turner's conviction for importing cocaine, because "much more cocaine is lawfully produced in this country," than is imported. Id. 396 U.S. at 418. In Leary v. U.S., 395 U.S. 641 (1968), the Court overturned a conviction where importation of marijuana had been inferred from possession despite its finding that "most domestically consumed marijuana is still of foreign origin." Id, 395 U.S. at 41. In reviewing these cases, the Court has concluded that the prosecution "may not rest its case entirely on a presumption unless the fact proved is sufficient to support an inference of guilt beyond a reasonable doubt." Ulster, 442 U.S. at 167.

Frequently in deciding whether an inference supports a presumption beyond a reasonable doubt, the Court has turned to the relevant legislative history to see whether Congress had addressed this question. In U.S. v. Gainey, 380 U.S. 63, 66-67 (1965), the Court held that "significant weight should be accorded to the capacity of Congress to amass the stuff of actual experience and call conclusions from it." Deference to legislative factfinding is especially appropriate when, as here, the matters are "not within the specialized judicial competence," and where "the exact relevance of a frequently occuring fact in an atmosphere pregnant with illegality" must be determined. Gainey, 380 U.S. at 66-67 (1965). This standard of deference was reaffirmed in Leary v. U.S., 395 U.S. 6, 35-36 (1968) (citing Gainey and adding "congressional determination favoring the presumption must, of course, weigh heavily"), and Turner v. U.S., 396 U.S. 398, 410 n. 10 (1970) (discussing at length the specific findings of fact made by the Senate Judiciary Committee). A legislative finding that the inference was appropriate would strongly influence any subsequent judicial scrutiny of the factual basis of the inference.

Analysis of the Act

A court reviewing a constitutional challenge to Section (b)(2) of the Act first would first examine the jury instructions to determine whether the presumption was mandatory or permissive. If permissive, the presumption would be constitutional so long as a rational connection exists between purchasing or selling a security while in possession of material, nonpublic information regarding that security or its market and directly or indirectly using the information in the trading decision. Ulster, 442 U.S. at 163.

If instead the reviewing court found that the jury instructions presented the presumption as mandatory, the court would go on to examine the Act on its face. The court would uphold the mandatory presumption if the facts of trading while in possession of the information are sufficient to support beyond a reasonable doubt the inference that the defendant directly or indirectly used the information. I believe that, especially in light of the Congressional determination as evidenced by the legislative history, a reviewing court would be satisfied that the connection between trading while in possession of the information and actually using the information is strong enough that it is fair to presume that the element of use is satisfied.

The Act distinguishes two categories of defendants: individuals and others. In the case of individuals, it is virtually certain that one who traded in a security while in possession of material, nonpublic information actually used that information, either directly or indirectly, when making his trading decision. As a result, the inference between trading while possessing the information and direct or indirect use of the information clearly satisfies the beyond a reasonable doubt standard.

In the case of defendants other than individuals, such as corporations, many minds may be at work and it is conceivable that one person within the corporation may possess the information and another may effect the trade, with no transmittal of the information actually occurring between them. In such a circumstance, the one effecting the trade would not actually use the information, but both would be working for the same corporation. Recognizing this possibility, the Act removes from the presumption the corporation which offers proof that it did not use the information in effecting the trade.

Having removed this clear exception, the Act structures the presumption as to non-individuals as a very narrow one: in circumstances where an individual or a group of individuals within the corporation both possesses the information and trades in the security, the presumption of direct or indirect use of the information holds true beyond a reasonable doubt. This is consistent with the application of the presumption as to individuals, recognizing that a group of individuals within a corporation may be acting together, sharing knowledge of the information and the decision to trade, establishing that the corporation itself is trading on the information. Thus, the presumption is constitutional, both as to individuals and as to others, who trade while in possession of material, nonpublic information.

Conclusion

As I mentioned to Senator Shelby in my letter of June 19, 1987, attached to this Memorandum as Exhibit B, and as set forth in this Memorandum, I believe that the presumption outlined in the Act would survive constitutional challenge because it does not shift the burden of proof of an element of the crime to the defendant. Rather, the strength of the inference of direct or indirect use is sufficient to satisfy the prosecution's burden of proof beyond a reasonable doubt. Indeed, a court may not need to reach the question of whether the presumption is supported by a sufficiently strong inference.

In the past, the U.S. Supreme Court has held that, where Congress could simply have prohibited the acts which the defendant was actually shown to have committed, then "the statute would be none the worse if it allowed a defense in the single case" where the presumption could be rebutted. This is because the statute "imposed a liability that was less than might have been imposed, and that being so, the thing to be considered is the result reached, not the possibly inartificial or clumsy way of reaching it." Perry v. Ramsey, 277 U.S. 88, 95 (Holmes, J.) (1927) (But see United States v. Romano, 382 U.S. 136, 144 (1965)). As Ferry held, the presumption of use of improper information may be construed, in effect, to eliminate that element of the offense. The opportunity to overcome the presumption would then be analogous to an affirmative defense, a result intended by the committee which drafted the Act. As I stated at the hearing, there is no question that requiring the defendant to prove an affirmative defense is constitutional. U.S. v. Custer Channel Wing Corp., 376 F.2d 675, 680 (4th Cir., 1967), cert. denied 389 U.S. 850 (1967).

In Ferry, Justice Holmes also noted that "[a]s a matter of law, there is nothing new in charging a party with knowledge of what it is his duty to know," 277 U.S. at 95. Here, the vast majority of the corporations are already charged with a duty to "maintain[ ] and enforce[ ] a reasonable and proper system of supervision and internal control over" their employees under § 20(a) of the Exchange Act of 1934, Zweig v. Hearst Corporation, 521 F.2d 1129, 1135 (9th Cir. 1975), cert. denied 423 U.S. 1025 (1975), and thus would be able to rebut the presumption.

In order to ensure that any legislation adopted by Congress would simplify and clarify the law on insider trading, however, it may be preferable to restructure the Act to define the crime expressly with an affirmative defense, rather than to use a mandatory presumption. Redrafting the Act in this fashion retains the essence of the initial version, but removes the "presumption" language which might otherwise have invited challenge on constitutional grounds. A revised subsection (b) which eliminates the criminal presumption is attached to this Memorandum as Exhibit C.

As the Subcommittee will note, the redrafted bill would eliminate entirely the requirement of proof that the defendant actually used the material nonpublic information regarding the securities in effecting the purchase or sale of the securities. Instead, the crime of insider trading would be defined as purchase or sale or securities while in possession of material nonpublic information. Subsection (b), as revised, would then establish an affirmative defense for defendants other than individuals which is similar to the provision for rebutting the presumption which appeared in the first draft of the Act.

Because direct or indirect use would no longer be an element of the crime of insider trading, the defendant's opportunity to offer an affirmative defense would present no constitutional problem. It is not the prosecution's burden to establish the nonexistence of all affirmative defenses -- only to prove the elements of the crime. Patterson v. New York, 432 U.S. 197 (1977). Although the prosecution must prove the elements beyond a reasonable doubt, the bill provides for specific circumstances when an affirmative defense is available when the defendant should not be liable for trading while possessing the information. This structure, like that of the original draft of the Act, maintains the balance of fairness required by the Constitution, but also eliminates the litigous "trigger" created by a criminal presumption.

Redrafting the Act to use an affirmative defense rather than a criminal presumption would avoid the immediate litigation which Senator Shelby suggested might arise. I believe that all of us prefer an Act which will carry on its own momentum, and without immediate constitutional challenge, the direct message that Congress will not tolerate insider trading.

cc: The Honorable Richard C. Shelby
Steve B. Harris, Esq.
Tom Lykos, Esq.

Attachments

Exhibit A

100TH CONGRESS
1ST SESSION
S.

To amend the Securities Exchange Act of 1934 to prohibit certain trading or communications by those who possess material, nonpublic information.

IN THE SENATE OF THE UNITED STATES

June __, 1987

____________________ introduced the following bill; which was read twice and referred to the Committee on Banking, Housing and Urban Affairs.

A BILL

To prohibit certain trading or communications by those who possess material, nonpublic information.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled.

SECTION 1. SHORT TITLE.

This Act may be cited as "The Insider Trading Proscriptions Act of 1987."

SEC. 2. INSIDER TRADING PROSCRIPTIONS.

Chapter 78 of Title 15, United States Code, is amended, by adding at the end of § 78p the following:

"Section 16A.

"(a) FINDINGS

"(1) The fairness, honesty and integrity of the nation's securities markets are impaired when corporate insiders and other persons who obtain material, nonpublic information relating to a particular security or group of securities (or the market for such security or group of securities) wrongfully use that information, or wrongfully communicate that information to others who misuse it, in connection with the purchase or sale of any security.

"(2) Effective prohibitions against trading by persons who wrongfully use material, nonpublic information, and wrongfully communicate that information to others who misuse it, are necessary to preserve the integrity of our markets and their ability to serve important national and international economic functions, including capital formation.

"(3) There is an important public interest in the prompt, unfettered flow to the securities markets of information.

"(4) The specific delineation of what constitutes the wrongful use or wrongful communication of material, nonpublic information provided herein is necessary to promote greater clarity in the law.

"(b) PROHIBITION AGAINST THE USE OF MATERIAL, NONPUBLIC INFORMATION

"(1) It shall be unlawful for any person, directly or indirectly, to use material, nonpublic information to purchase or sell any security, by the use of any means or instrumentalities of interstate commerce, or of the mails, or of any facilities of any national securities exchange, or of any automated quotations system maintained for the trading of securities, if such person knows or is reckless in not knowing that such information has been obtained wrongfully, or if the purchase or sale of such security would constitute a wrongful use of such information. For the purposes of this Section, information shall have been used or obtained wrongfully only if it has been obtained by, or its use would constitute, directly or indirectly, theft, conversion, misappropriation or a breach of any fiduciary, contractual, employment, personal or other relationship of trust and confidence.

"(2) For purposes of subsection (b)(1), any person who purchases or sells a security while in possession of material, nonpublic information relating to that security (or the market therefor) shall be presumed to have used that information in connection with such purchase or sale. Notwithstanding the foregoing, in the case of a person other than a natural person, the presumption that such material, nonpublic information in that person's possession was used in connection with transactions in that security shall be overcome if such person sustains the burden of proving that:

"(A) the purchase or sale of the security was not influenced by such material, nonpublic information; and

"(B) the individual effecting the purchase or sale, or causing others to purchase or sell, on behalf of such person, did not know the material, nonpublic information.

In determining whether any person other than a natural person has sustained its burden of proof under this subsection, it shall be relevant whether, and to what extent, such person had implemented and maintained reasonable policies and procedures to prevent violations of this Section by the individuals making or influencing investment decisions on its behalf.

"(c) PROHIBITIONS AGAINST THE WRONGFUL COMMUNICATION OF CERTAIN MATERIAL, NONPUBLIC INFORMATION

"(1) It shall be unlawful for any person, directly or indirectly, wrongfully to communicate material, nonpublic information to another person who, directly or indirectly, purchases or sells any security that is directly or indirectly the subject of the communication, while in possession of such information, if the person making the communication knows (or is reckless in not knowing) that such information would be used for a purchase or sale of a security that would violate subsection (b) of this Section.

"(2) It shall be unlawful for any person planning an acquisition or disposition of an issuer, a material block of the issuer's securities or its assets, or any person acting on behalf of such a person (herein the "transacting person"), for the purpose of influencing or encouraging the purchase or sale of the securities of such issuer, to communicate, directly or indirectly, material, nonpublic information concerning such plans to any other person who thereafter purchases or sells the affected securities, unless such other person is acting on behalf of or as part of a group with the transacting person (within the meaning of Section 13(d)(3) of this Title) or the communication of such information has been made in the course of a good faith solicitation of such other person to act on behalf of or as part of a group with the transacting person (within the meaning of Section 13(d)(3) of this Title) or the securities are acquired directly from or sold directly to the transacting person.

"(d) DERIVATIVE LIABILITY

No person shall be liable under this Section solely by reason of the fact that such person controls or employs a person who has violated this Section, if such controlling person or employer neither participated in, nor directly or indirectly induced the acts constituting the violation of this Section.

"(e) COMMISSION RULEMAKING AND ORDERS

The Commission may, by rules consistent with the provisions of this Section, implement the provisions of this Section. The Commission, by rules, or by order, may exempt any person, security or transaction, or any class or classes of persons, securities or transactions, from any provision or provisions of this Section, if and to the extent that such exemption is consistent with the provisions of this Section.

"(f) PRIVATE RIGHTS OF ACTION

Any person who is injured by a violation of this Section in connection with the purchase or sale of any security may recover any damages sustained by reason of such violation. For the purpose of this Section, a person shall be deemed to have been injured by a violation of this Section if such person has purchased or sold the affected securities contemporaneously with the transactions in such securities that form the basis of the violation of paragraphs (b) or (c) of this Section. No person shall be liable in damages in any action under this subsection for an amount in excess of such person's actual profit obtained or loss avoided. Any damages imposed against any person under this subsection shall be diminished by (and, where available, recovered from) the amounts, if any, that such person may be required to disgorge, pursuant to a court order obtained at the instance of the Commission, in a proceeding brought under Section 21(d) of this Title relating to the same transaction or transactions. Any person who violates subsection (c) of this Section shall be liable, jointly and severally, to the same extent as any persons who obtained profits or avoided losses as a result of such violations of subsection (c). The period of limitations for the commencement of any action under this subsection shall be the same as that provided in Section 21(d)(2)(D) of this Title [the Insider Trading Sanctions Act].

"(g) EXCLUSIVITY

This Section shall provide the exclusive standards by which the wrongful use or wrongful communication of material, nonpublic information in connection with the purchase or sale of a security shall be addressed. This Section shall not, however, affect other prohibitions or requirements of law based, in whole or in part, on conduct other than such wrongful use or wrongful communication of material, nonpublic information.".

SEC. 3. EFFECTIVE DATE.

This Act shall take effect immediately upon enactment of this Act.

Exhibit B

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HARVEY L. PITT
DIRECT LINE (202) 639-7100

June 19, 1987

Senator Richard C. Shelby
Securities Subcommittee to the Senate
  Committee on Banking, Housing and
  Urban Affairs
313 Hart Senate Office Building
United States Senate
Washington, D.C. 20510-6075

Dear Senator Shelby:

During the June 17, 1987 hearings before your Securities Subcommittee regarding the proposed "Insider Trading Proscriptions Act of 1987" (the "Act"), you inquired whether the use of a presumption in the Act would raise constitutional questions, as this legislation, if enacted, would form the basis for criminal prosecutions, as well as civil litigation and enforcement proceedings. Your concerns are well founded. There are many judicial decisions examining the constitutional validity of presumptions within criminal statutes. (See, e.g., County Court of Ulster County, New York v. Allen, 442 U.S. 140 (1979); Mullaney v. Wilbur, 421 U.S. 684 (1975); In re Winship, 397 U.S. 358 (1970); Leary v. United States, 385 U.S. 6 (1968); Tot v. United States, 319 U.S. 463 (1942).) For your reference, I am planning to forward to you a memorandum which discusses the relevant cases and analyzes the language of the proposed bill against the constitutional standards articulated by the Supreme Court. While I believe that the bill accommodates even the most cautious Supreme Court articulations regarding such presumptions, your concern that the statute would be challenged aggressively from the moment of its adoption is surely a concern shared by those of us who drafted the proposed bill.

In response to your concern that the creation of a criminal presumption would lead to immediate litigation, and because we share the goal of simplifying the articulation of the offense

Senator Richard C. Shelby
June 19, 1987
Page 2

to clarify the law of insider trading rather than create new ambiguities, we have redrafted subsection (b) of the Act to provide an even clearer definition of the offense. As you will note in reading the attached copy of the redrafted bill, the requirement of proof that the defendant actually used the material nonpublic information regarding the securities in effecting the purchase or sale of the securities would be eliminated entirely. Instead, the crime of insider trading would be established when a defendant purchases or sells securities while in possession of material nonpublic information. Subsection (b), as revised, would then establish an affirmative defense for non-natural persons which is similar to the express provision rebutting the presumption which appeared in the first draft of the Act. This balance captures the intentions of the original proposed Act while eliminating the criminal presumption which otherwise might have encouraged constitutional challenge.

I am looking forward to discussing the attached draft of revised subsection (b) with members of your Subcommittee and I urge you to contact me with any questions or comments you might have.

Sincerely,

Harvey L. Pitt kls

Harvey L. Pitt

Enclosures

Exhibit C

Revised 7/13/87

(b) Prohibitions Against ~~The/Use~~ Trading Securities While in Possession of Material, Nonpublic Information

(1) It shall be unlawful for any person~~, directly or indirectly, to use material, nonpublic information~~ to purchase or sell any security while in possession of material, nonpublic information, by the use of any means or instrumentalities of interstate commerce, or of the mails, or of any facilities of any national securities exchange, or of any automated quotations system maintained for the trading of securities, if such person knows or is reckless in not knowing that such information has been obtained wrongfully, or if the purchase or sale of such security on the basis of such information would constitute a wrongful use of such information. For the purposes of this Section, information shall have been ~~used or~~ obtained wrongfully or would be used wrongfully, only if it has been obtained by, or its use would constitute, directly or indirectly, theft, conversion, misappropriation or a breach of any fiduciary, contractual, employment, personal or other relationship of trust and confidence.

(2) ~~For purposes of subsection (b)(1), any person who purchases or sells a security while in possession of material, nonpublic information relating to that security or the issuer thereof shall be presumed to have used that information in connection with such purchase or sale.~~ Notwithstanding the foregoing, in the case of a person other than a natural person, ~~the presumption that such material, nonpublic information in that person's possession was used in connection with transactions in that security shall be overcome~~ no liability under subsection (b)(1), above, shall arise if such person sustains the burden of proving that:

(A) the purchase or sale of the security was not influenced by such material, nonpublic information; and

(B) the individual effecting the purchase or sale, or causing others to purchase or sell on behalf of such person, did not know the material, nonpublic information.

In determining whether any person other than a natural person has sustained its burden of proof under this subsection, it shall be relevant whether, and to what extent, such person had implemented and maintained reasonable policies and procedures to prevent violations of this Section by the individuals making or influencing investment decisions on its behalf.

Revised 7/13/87

(b) Prohibitions Against ~~The Use~~ Trading Securities While in Possession of Material, Nonpublic Information

(1) It shall be unlawful for any person~~, directly or indirectly, to use material, nonpublic information~~ to purchase or sell any security while in possession of material, nonpublic information, by the use of any means or instrumentalities of interstate commerce, or of the mails, or of any facilities of any national securities exchange, or of any automated quotations system maintained for the trading of securities, if such person knows or is reckless in not knowing that such information has been obtained wrongfully, or if the purchase or sale of such security on the basis of such information would constitute a wrongful use of such information. For the purposes of this Section, information shall have been ~~used or~~ obtained wrongfully or would be used wrongfully, only if it has been obtained by, or its use would constitute, directly or indirectly, theft, conversion, misappropriation or a breach of any fiduciary, contractual, employment, personal or other relationship of trust and confidence.

(2) ~~For purposes of subsection (b)(1), any person who purchases or sells a security while in possession of material, nonpublic information relating to that security, not the market generally, shall be presumed to have used that information in connection with such purchase or sale.~~ Notwithstanding the foregoing, in the case of a person other than a natural person, ~~the presumption that such material, nonpublic information in that person's possession was used in connection with transactions in that security shall be overcome~~ no liability under subsection (b)(1), above, shall arise if such person sustains the burden of proving that:

- (A) the purchase or sale of the security was not influenced by such material, nonpublic information; and
- (B) the individual effecting the purchase or sale, or causing others to purchase or sell on behalf of such person, did not know the material, nonpublic information.

In determining whether any person other than a natural person has sustained its burden of proof under this subsection, it shall be relevant whether, and to what extent, such person had implemented and maintained reasonable policies and procedures to prevent violations of this Section by the individuals making or influencing investment decisions on its behalf.

Senator RIEGLE. Now let me ask our next witness to come to the table, Mr. Henry Manne, of George Mason University, who has quite a different view on this, and I'm wondering—let me invite him to come up now—I'm wondering if the two of you would be in a position to stay a bit because we might want to sort of maybe have some discussion back and forth on some of the issues that will arise here. Are either of you in a position to stay a bit longer?

Mr. PITT. Certainly.

Mr. OLSON. Fine.

Senator RIEGLE. Mr. Manne, we're delighted to have you and why don't you go ahead and make your presentation.

STATEMENT OF HENRY G. MANNE, GEORGE MASON UNIVERSITY, SCHOOL OF LAW, ARLINGTON, VA

Mr. MANNE. Thank you, Mr. Chairman. I am very honored to be here and I thank the members of the committee for inviting me.

As you may know, in 1966, I published a book entitled "Insider Trading in the Stock Market," which as far as I know was the first scientific and rigorous academic analysis of this subject. It did defend in some respects the practice of insider trading, not in any sense any part of it that represented for the manipulation, breach of contract, or any other inherently bad behavior.

The tide of thinking on that subject is very different today than it was in 1966. I believe in 1966 that I was probably the only person in the country taking that position. Today, there are vast numbers of economists, academic and otherwise, who understand the point about the efficient market, that insider trading does play a role in that.

Nonetheless, it is still difficult to oppose a very strongly held emotional position. I view that as part of my job as an honest academic and I might say in way of passing that this is one of the reasons academics are accorded the benefits of tenure and academic freedom.

Nonetheless, I am not here to discuss this question of efficient markets. I don't think that it is fully central to the bill proposed. I do think, however, that the issue of tender offers on which I have also written for close to 35 years is very much involved. For Mr. Pitt to say that this bill has nothing to do with tender offers violates I think the most cardinal rule that economists live by, namely that demand curves slope down and supply curves slope up.

The Williams Act, as is well known, can be viewed as a matter of fact was indicated in the explanatory memorandum to this bill—can be quite correctly viewed as a significant law against insider trading. What it provides, however, is very interesting and that is that evil though it may be, the raider is allowed 5 percent of the shares. He may make the profit on his undisclosed information that he plans a takeover on 5 percent. Originally, in the original act, that was 10 percent, but the people against tender offers liked it so much they reduced it to 5 percent. Effectively today, it's probably still close to 10 percent because of the window allowing some additional purchases of shares.

Now the effect of that rule is a price control mechanism. It simply limits the amount of profitability that can be had on takeovers. If the figure were larger than 5 or 10 percent, clearly there would be more takeovers. That's the notion of an upward sloping supply curve. If the figure is made less by say closing the window, then quite clearly there will be fewer takeovers.

TAKEOVERS ARE A FINANCIAL PHENOMENON TODAY

The takeover is certainly a central financial phenomenon in American business life today. I honestly believe that it is vastly more important in its significance in the role it plays in keeping the American corporate system healthy than is the topic of insider trading. That is not to belittle the latter topic. It's simply to indicate that this has a kind of central role in the operation of a publicly held corporate system that nothing else does. We don't have alternative devices to the tender offer that are anywhere near as efficient in correctly policing either inefficiency or misbehavior on the part of corporate executives.

Widely diffused shareholders with tiny fractions of the shares are simply not in a position to do anything. The courts through derivative suits can only touch the most blatant kind of mismanagement. Subtle inefficiency can simply not be dealt with in that fashion. I think this is generally recognized today. No one today, unlike perhaps 20 years ago, is suggesting that we ought to outlaw the hostile tender offer altogether.

Nonetheless, the fact remains that without something that looks like insider trading and that is very much covered by this bill that these tender offers wouldn't occur. If in fact the original Williams Act had been effective in holding every raider to a return on 5 or even 10 percent of the shares, I think we would see literally almost no hostile takeovers today.

Now it is not by any means to justify the behavior of Messrs. Boesky, Levine or others in some of the tactics they used to suggest that it was the existence of the Williams Act that created the necessity of doing something else if tender offers were to occur. In fact, their behavior allowed these things to go on.

Now how could that be? They did three things basically since the Williams Act had prevented the full profitability on the information that the raider had established.

The first thing they did was make it clear to the raider that the shares would be there at the time the offer was actually announced.

The second thing, he would now know the price. Under the old scheme, the price was a mystery and clearly he would have to offer more to guarantee a sufficient percentage of the shares.

Third, that the shares could be delivered in a very efficient fashion. All of this substantially lowered the cost of running takeovers. That meant that even with the restricted profitability on the information that the raider might have, these things could still go on.

Now it's hard to believe that a great deal of the attention being paid to insider trading today doesn't evolve out of the *Boesky* case. While it's true that the emotional focus is on the insider trading, the deception, the inducement of breach of fiduciary duties, and employment contracts and things of that sort, nonetheless, the concern that seems to be voiced most significantly is that let's get rid of this because this clearly demonstrates that these takeovers were generating a lot of bad behavior.

Now the truth of the matter is that the Williams Act was generating a lot of bad behavior. It left things profitable enough that some people were willing to take the risk of engaging in illegal behavior. The parallel to the operation of the black market in Russia is 100 percent, and yet the Russian economy probably could not survive today if it were not for those criminals who were willing to sell goods on the black market.

At any rate, I believe that that part of this current bill raises very significant questions that ought to be addressed apparently differently than Mr. Pitt and Mr. Olson have.

Having said that, however, I want to congratulate them on some other aspects of this bill. By defining wrongful uses of inside information, the bill makes it clear that any other use of information would not be wrongful. In fact, in the definition section it indicates explicitly that these are the only forms of wrongful behavior. This allows for the first time something that I and a number of other people, including a substantial element on the Securities and Exchange Commission, have proposed; namely, that when there is no inherent evil in certain regulatory provisions, that parties be allowed to contract out of them.

Under this rule, a corporate board of directors who agreed with the widely held academic position that insider trading can be used as an effective device for motivating corporate executives, similar to participation in patent royalties, a board could with proper public disclosure authorized trading by certain individuals. I think this is a definite advance, a very laudible form of deregulation that is long overdue, both in connection with insider trading and other parts of securities regulation.

The other points I think I would leave for questions if you have any. I haven't addressed a number of details in the act but these were the major points that I would like to touch.

[The complete prepared statement of Henry G. Manne follows:]

Testimony of
Henry G. Manne, Dean
George Mason University
School of Law

There is perhaps no better way to begin my discussion of the pending Bill on insider trading than to paraphrase the piece I wrote for The New York Times that was published on November 25, 1986, at the very height of outrage about the Boesky disclosures. In this piece I sought to explain the relationship between enforcement of the S.E.C.'s insider trading rules and Congressional actions, notably the Williams Act, to regulate corporate takeovers. I believe that my analysis demonstrated this connection for the first time, but it is amply confirmed by the Bill presently under consideration. After my summary of this background material, I shall turn my attention to what I consider to be the major issues in the pending Bill.

During the 1960's, the takeover phenomenon accelerated at a rapid and, to some people, frightening pace. It so threatened some members of the established corporate community that they sought and obtained protection from Congress.

The main result was adoption of the Williams Act in 1968. That Act and related Securities and Exchange Commission rules effectively required that a bidder who has bought 5 percent of the shares of a target company in the open market disclose his takeover plans to the public and not make further open market purchases. Clearly, when such a "raider" has correctly identified a target company and formulated a takeover plan, he possesses valuable undisclosed information. The more shares the bidder can acquire before disclosing his takeover intention, the more likely is his plan to succeed and the more profitable will his effort be. The 5 percent rule therefore limited the profitability of a tender offer.

The rule was plainly aimed at reducing the number of tender offers. But the popularly accepted explanation for the Williams Act was that it was aimed at abuses connected with the so-called midnight special. Under this older, simpler approach to tender offers, a few people might gather in a hotel room over a weekend, formulate a takeover plan and advertise for the desired shares in Monday morning's New York Times and Wall Street Journal. Little information about the bidders would be given and often less than a week would be allowed for tendering shares.

Under this practice, a raider could easily determine who would have access to his information. If only a few people were in on the plan, there was little danger of unauthorized leaks. And the raider would know in just a few days whether his takeover would be successful or not. Thus, his period of exposure to the extremely high interest charges on the money borrowed for the takeover would be limited.

Despite the fact that no one has ever demonstrated that these practices in aggregate cost shareholders money, the Williams Act changed the old way of doing things. And it was not surprising that new techniques soon developed. Confronted with the 5 percent rule, the bidder needed a fresh device that would increase his knowledge of how many shares might be offered at a given price, assure the availability of large blocks of shares when needed and allow him to control the flow of valuable information. Foremost among these new devices was what we now call "risk arbitrage." This is basically a matter of "pre-positioning" or "parking" shares before a tender offer is made public. The most successful of the new breed of risk arbitrageurs was Mr. Boesky.

The arbitrage function probably evolved in the marketplace without any direct communication between the arbitrageurs and the raiders themselves. The raider would know just by watching the tapes what the arbitrageurs were doing; and the arbs would know from their trading profits whether they were getting reliable information about pending takeovers. The fact remains, however, that systematic access to valuable information such as Mr. Boesky had about forthcoming takeovers could probably not be gained without at least the tacit approval of the raiders. There has been sufficient evidence for the S.E.C. to implicate other Wall Street figures in the Boesky case, but so far no prominent corporate "raider." However, the fact that the raiders themselves might be implicated is one reason why there are a lot of happier faces in some of America's executive suites.

The smiles would be even broader if the Boesky case can be used to justify additional regulations making tender offers even more difficult to mount. But the damage to American investors would then be even greater. The tender offer is the most important and beneficial financial invention of the 20th century. Its very existence has probably added hundreds of billions of dollars to American capital values. Without it, noncontrolling shareholders in companies with widely diffused ownership are nearly helpless in the face of managerial incompetence, self-dealing or inattention to business.

The S.E.C.'s crusade against insider trading has been on a collision course with desirable takeover policy for a long time. The Commission has been so blind to arguments that insider trading is harmless and even beneficial that it has now stumbled like a drunken sailor into the fragile, complex apparatus of post-Williams Act takeovers.

The S.E.C., the public, and Congress should be aware of just how high the Commission has raised the stakes in the stock market game. If the insider trading net is extended to cover the activities of takeover activists like Carl Icahn or Victor Posner, this could ultimately cause the most serious permanent decline in stock values in modern history. The Williams Act should be repealed forthwith; its very existence exerts a tremendous downward pressure on stock prices.

The pending Bill confirms everything I have suggested. It does nothing to strengthen the existing rules against insider trading. In fact it contains probably one of the most notable deregulatory moves that we have seen in this field, and one to be highly commended. By defining "wrongful" uses of inside information, the Bill makes it clear that any other use of information would not be wrongful. Thus a corporate board of directors who agreed with the widely-held academic position that insider trading can be used as an effective device for motivating corporate executives, could, with proper public disclosure, authorize trading by certain individuals. For some time there has been a strong element on the Securities and Exchange Commission that favored this idea of "contracting out" of regulatory provisions. I am pleased to see that Congress has adopted this salutary point of view, since no one can be injured by a properly disclosed corporate provision allowing insider trading. This recognition of a position strongly held by a number of economists and law professors is much to be applauded.

But this Bill also confirms my earlier suggestion that the hostile takeover, and not insider trading, is the real target of current political action. By focusing its enforcement strength on the use of information by control acquirers and arbitraguers the Bill significantly boosts the anti-takeover force of the Williams Act.

The proposed legislation, like the Williams Act before it, uses a rule against insider trading to deter takeovers. Given the easy proof of guilt requirements for insider trading charges against arbitraguers and control acquirers - as compared to the relaxed standard and approval of the Chinese Wall scheme for investment banking houses - a fair reader would conclude that the Bill is aimed mainly at takeovers. Perhaps while shooting at one target, the drafters of the Bill have hit an entirely different one. The target they have hit, hostile takeovers of publicly-held corporations, needs to be understood and nurtured for the ultimate protection of American and foreign investors in American corporations and not hindered further. Takeovers should not be attacked under the guise of a moral crusade against insider trading, when in fact that is not even a serious evil in itself.

Senator RIEGLE. Very good.

Senator Shelby, do you have any questions?

Senator SHELBY. I'll try to be very brief. Dean, you're the dean of the law school at George Mason University and I'm sure you've been through a lot of securities law over the years and written books and so forth.

You were sitting in here earlier and, of course, I don't know—I just raise the point of the statutory presumption dealing with securities and who possesses material and so forth. In other words, it looks to me like that's a burden of proof shift there and I don't know if you teach criminal law or constitutional law.

Mr. MANNE. We certainly do in the law school.

Senator SHELBY. That certainly bothers me as a Member of the Senate up here.

Mr. MANNE. Senator, I think you are perfectly correct to be bothered by that. I have been bothered by an aspect of that even under present law because there are a lot of people who are simply put at risk who probably shouldn't be.

Under this bill, however——

Senator SHELBY. Many are innocent and then the burden becomes on them rather than the prosecution.

Mr. MANNE. Let me give you a simple scenario of the kind that happens, I think, every day and that is that a broker calls a customer and says, "Have I got a stock for you." Now the broker does this a lot.

Senator SHELBY. All the time.

Mr. MANNE. In fact, every time a broker calls he in effect says that I've got inside information because if you ask one of them why is this stock going to go up in price, he tells you, "Well, there's some information that's about to come out," and I always say, "Well, why hasn't the market already reflected this?" Because I do believe in an efficient market and typically he will say, "Well, it's because people don't know it."

Now every now and then a customer decides to have a flyer. He doesn't go to Las Vegas that week. He simply has a flyer on this stock. This time, for some poor schnook, that broker turned out to be correct. Most of the time he's not, this time in fact what he was saying was absolutely true. As far as the customer is concerned, he has taken a tip that he knows is valuable undisclosed public information.

Now I don't believe we want to make that criminal behavior. I think it raises too much of a possibility of abuse that you can point the finger at anyone who might be unpopular politically or otherwise, and put the burden on them to show that they didn't use information.

Senator D'AMATO. Could I just interrupt?

Senator SHELBY. Go ahead. I yield.

Senator D'AMATO. Just on this for clarification because, Dean, I don't see anyway, anyhow—first of all, we would not want to make that criminal conduct and I'm going to ask Mr. Olson or Mr. Pitt to reply to that, but in essence what the dean has pointed out is the case where the broker calls up and says, "I've got some great information." It turns out that his recommendation to buy a stock turns out to be tremendously accurate. The stock doubles or triples.

Reply to that. Is he going to be held under this criminally?

Mr. MANNE. If he says anything other than "This is my recommendation." If he says, "This is a tip based on something I've heard or knowledge that's not yet in the marketplace"——

Senator D'AMATO. It's your contention that he would be held, Mr. Olson?

Mr. MANNE. I think so. I think at least there is a presumption that that customer knows he has information that is wrongfully obtained.

Senator D'AMATO. Let's ask Mr. Olson. Would that be the case?

Mr. OLSON. I wouldn't come out the same way on those facts.

Mr. PITT. I wouldn't either.

Senator D'AMATO. Would you explain why?

Mr. OLSON. Well, because I don't think that the customer knows that the information has been obtained—first of all, the customer is not using the information improperly.

Senator D'AMATO. What about the broker?

Mr. OLSON. Second, he doesn't know nor is he reckless in not inquiring into the broker's misusing it. The broker is not anybody's fiduciary other than the customer's.

Senator D'AMATO. Well, what about the broker, Mr. Pitt?

Mr. PITT. I think that John has captured it. I don't think under our provision there would be the slightest problem where the customer didn't know and where there was nothing that created any reason for people to say that the customer was reckless in not knowing.

Senator D'AMATO. I'm not concerned about the customer. I'm concerned about the broker. Would you have it where he went and eavesdropped or he illicitly obtained this information but not that he got it from——

Mr. OLSON. Well, you're right, Senator. It's the same answer for the broker. Unless the broker stole the information or knew it was reckless in not knowing that it was stolen, he wouldn't be liable. The fact that you hear a rumor doesn't create liability under this statute. It was not intended to.

Mr. MANNE. This is not a rumor, but that's not the problem. The problem is that a person can be accused and the burden is then on that person to establish that he didn't know that this was wrongfully obtained.

Senator SHELBY. That's the third question I raised earlier.

Mr. OLSON. That defect exists much more dramatically under the present law than it ever would under this statute.

Mr. MANNE. It exists in both, I agree.

Senator D'AMATO. Now the issue is joined for the first time, if I might be so bold, and I finished up in the bottom of the class in law school, not the top, Dean.

Mr. MANNE. You must have been top in advocacy, Senator. Some of our best students are at the bottom of the class.

POSSIBILITY OF LIABILITY

Senator D'AMATO. The question is, whether or not you have a greater liability—the possibility of liability now under the case law theory as opposed to the definition, and I'd like to ask you, in all due candor, it would seem to me that even in one of your presentations you suggested that this law is better than—not that your advocating it—but better than the present situation as it relates to clarity as to where that responsibility will or will not fall or the liability.

Mr. MANNE. My principal defense of this is that it does incorporate the idea of contracting out on this issue.

Senator D'AMATO. We'll return to that contracting out. That's another question.

Mr. MANNE. On this issue——

Senator D'AMATO. On the issue of possible criminal exposure, isn't the broker under this law better off as opposed to the present status?

Mr. MANNE. I'm not sure that the broker is. I was addressing more the issue of the customer, but I think the same thing is true of brokers.

Senator D'AMATO. Well, customer or broker?

Mr. MANNE. A great many of the brokers are rather innocent, but they do frequently claim to have inside information.

Senator D'AMATO. They all do.

Mr. MANNE. Now suppose after the fact it turns out that there was a leak of information. How can someone prove, having said that this is undisclosed information that in fact he really didn't know it, that he was lying? And that's a problem.

Senator SHELBY. The burden ought to be, in my opinion, on the prosecution to prove this. The man or lady shouldn't have to prove something because if they've been indicted the prosecution ought to prove it.

Mr. PITT. Can I just say one thing? I've asked that we supply you with a very full response to this and hopefully either today or tomorrow.

Senator SHELBY. Will you?

Mr. PITT. But I do want to point out that the courts and the—I'm sitting here and it's difficult to do research and search back through your mind, but I know that the courts under the Securities Act of 1933, any sale of public securities in interstate commerce must be registered and the failure to register them is a violation of the law. The statute, however, provides exemptions. But the burden of proof is on the defendant to prove his entitlement. The Supreme Court has addressed that issue. That's a criminal provision and in the fourth circuit in Maryland, *United States* v. *Custer Channeling* I think is the case, a conviction was sustained precisely because the defendant did not sustain the burden of proving that he was entitled to the exemption. That is to say, there was a statutory presumption of violation, there were defenses, that is exemptions you could rely on, and you, the defendant, had the burden. And that's been in the law since 1933.

Senator SHELBY. Did the Federal court deny certiorari on this and how long ago has this been?

Mr. PITT. I don't know whether they did or not. Custer Channeling is I think the 1960's. The Supreme Court in a civil case, however, SEC against Ralston Purina in 1953——

Senator SHELBY. A different burden of proof in civil.

Mr. Pitt. There's no doubt, but in 1953, in recognizing that this statute, No. 1, applies both civilly and criminally, and in *Chiarella*, footnote 20 refers to the problems and says they're the same with respect to civil and criminal liability, and that's why he criticizes 10(b)(5). The Supreme Court in the *Ralston Purina* case specifically said that the burden is on the defendant always under the securities laws to prove entitlement to exemptions.

Senator Shelby. Well, it ought to be changed if that's what they're saying.

Mr. Manne. Exactly the point. I think there are some other areas of constitutional law as well in which the presumption notion has been pushed close to the line.

But the question is, whether in a situation like this, it's appropriate legislation to put the burden on any number of people who may be targeted for reasons that we can't even guess at this point, whether the burden should be put on them to prove their innocence.

Senator Riegle. Thank you very much for your testimony.

We have one more witness, Mr. Gary Tidwell, to call and we're running quite late, so let me thank all three of you for your comments and participation today and let me call Mr. Tidwell to the table.

I understand, Mr. Tidwell, you are accompanied by Mr. Aziz, who has helped you with your survey material, and we welcome him as well.

Mr. Tidwell, you are associate professor of business administration at the College of Charleston in South Carolina, and we're delighted to have you and would be pleased to hear from you now.

STATEMENT OF GARY L. TIDWELL, ASSOCIATE PROFESSOR OF BUSINESS ADMINISTRATION, COLLEGE OF CHARLESTON, CHARLESTON, SC; ACCOMPANIED BY ABDUL AZIZ, ASSISTANT PROFESSOR OF BUSINESS ADMINISTRATION, COLLEGE OF CHARLESTON, CHARLESTON, SC

Mr. Tidwell. Thank you, sir.

Mr. Chairman and members of this Senate subcommittee, I'm honored that you have asked me to testify today concerning the results of a survey which Dr. Abdul Aziz and I have recently completed. We are both professors in the School of Business and Economics at the College of Charleston.

The purpose of our study was to examine a limited number of retail stock brokers to determine their understanding of the insider trading laws. Our study was prompted when we became aware of polling data that indicated that 71 percent of Americans feel that insider trading should be illegal, but yet another poll indicated that 70 percent of Americans felt insider trading was common among investment professionals. That data, spurred our research.

We began with the theory and hypothesize that when examining traditional insider trading—that is, trading by officers and directors—most people understand the law. But when people had to apply the court or judicially created theories of misappropriation, temporary insider, or tipper/tippee liability, the law was unclear and they would be unable to apply that law.

We specifically speculated that to most people, including the so-called market professionals, the law concerning insider trading is murky and either not understood or is misunderstood. My speculation was based in part on contacts I had with those in the securities field when I was an attorney in the Division of Enforcement at the SEC.

We studied 121 different stock brokers from brokerage firms in Charleston, SC; Columbia, SC; Charlotte, NC; and Atlanta, GA. These brokers participated on a voluntary basis. Our survey was based on a questionnaire consisting of 12 objective questions derived from 10 different factual situations. These factual situations were based on principles that were derived from previously litigated cases concerning insider trading.

The brokers who participated in our survey were assured of complete anonymity. The results of our data was collected between April 9, 1987 and May 10, 1987.

For purposes of comparison of scores made by the stock brokers, we sampled 153 primarily sophomore business students at the College of Charleston. We also sampled 28 other business students who had previously studied insider trading.

RESULTS OF SURVEY

The results of our survey are found on page 4 of our written document that was previously submitted to this committee. I think the significant data that arises from that document would be as follows.

The brokers scored 60 percent. They had a mean correct answer of 7.3 out of 12. The students who had previously studied insider trading averaged 75 percent. They had a score of 9.00. The students who had not studied insider trading scored 6.14 or 51 percent.

Specifically, our survey resulted in the following significant findings. First, the students who had previously studied insider trading scored higher than the brokers on 8 of the 12 questions. The students who had not studied insider trading scored higher than the brokers on 3 of the 12 questions. The scores made by the brokers ranged from a high of 10 correct responses or 83 percent to a low of 3 correct responses or 25 percent.

Eighty-four percent of the brokers mistakenly believe that insider trading was defined by the Federal securities laws which, of course, we well know it is not. Thirty-eight percent of the brokers failed to identify insider trading in two situations raising the misappropriation theory. Sixty-seven percent of the brokers failed to recognize insider trading in a case that was very similar to the Wall Street Journal *Winans* case. Forty-five percent of the brokers failed to identify insider trading in a tippee situation.

Students who had not studied insider trading scored only 2 percent lower than the brokers on the questions relating to tippee liability and, of course, tippee liability is an insider trading area that is most likely to confront brokers. To us—or at least to me, this was one of the most amazing parts of the survey, that the students who had never even studied insider trading only scored 2 percent lower than the brokers in the very area of insider trading that is most likely to confront the brokers.

Seventy-one percent of the brokers provided a response that would indicate they were not aware of the possibility of liability in a false tip situation whereby the broker provides a false tip to a client.

Then last, and maybe even most important, was the very interesting data that we collected concerning whether or not brokers felt they were satisfied with their understanding of insider trading.

We actually found that brokers who indicated they were satisfied with their understanding of insider trading did worse on the survey than the brokers who indicated that they were not satisfied with their understanding of insider trading.

So if you were a broker and filled out the survey and you indicated that you weren't satisfied with your understanding of insider trading, you probably did better on the survey than the other brokers the 67 percent of the brokers who indicated that they were satisfied with their understanding of insider trading.

Our study indicates that in all factual situations brokers could not successfully apply the judicially created definition of insider trading. We believe that it is because of a lack of a clear definition of insider trading that a confusion exists in distinguishing lawful from unlawful conduct. One can only speculate as to other groups understanding of the current insider trading rules.

It seems to us that a clear, concise, statutory definition of insider trading is needed. A clear, concise definition of insider trading needs to be designed to delineate lawful from unlawful conduct. This, combined with an aggressive and a comprehensive training program should decrease the incidence of insider trading and increase investors' confidence in our capital market system.

We want to thank you today for being able to present the results of our study to you, Senator, and if you have any questions we'd be glad to entertain them at this time.

[The complete prepared statement of Gary L. Tidwell and Abdul Aziz follows:]

"A Study of Stockbrokers' Understanding of Insider Trading"

Submitted to the Securities Subcommittee

Of The Senate Banking Committee

by

Gary L. Tidwell *
Associate Professor of Business Administration

and

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A Study of Stockbrokers' Understanding of Insider Trading

I. Introduction

Insider trading and the ethics of Wall Streeters and those in the securities field continue to be a major topic of discussion in 1987. Specifically, the investigation and litigation involving the insider trading activities of Dennis Levine, Ivan Boesky, and their associates have triggered a renewed interest in insider trading and business ethics.

Involvement of individuals or firms in insider trading violates the antifraud provisions of the federal securities laws, and may result in the imposition of significant penalties which were set forth by Congress in 1984 when it passed the Insider Trading Sanctions Act (ITSA).[1]

Despite the high visibility of insider trading and the recent number of cases that have been brought alleging insider trading,[2] there is no statutory definition of insider trading. Instead, the definition of insider trading and the application of this definition to a myriad of factual situations have been left to the courts.

The purpose of this study was to examine a limited number of retail stockbrokers ("brokers") to determine their understanding of insider trading. The sample of our study included brokers in Charleston, South Carolina, Columbia, South Carolina, Charlotte, North Carolina, and Atlanta, Georgia.

II. Background

As noted above, there is no statutory definition of what conduct constitutes illegal insider trading. However, insider trading has generally been defined by the courts as trading in a security based on material nonpublic information that was obtained in breach of a fiduciary duty. This definition of insider trading evolved from the Supreme Court cases of Chiarella v. United States,[3] and Dirks v. Securities and Exchange Commission.[4] Constrained by this narrow definition of insider trading, the Securities and Exchange Commission (SEC) through its litigation, has thus far been able to expand and broaden the definition of insider trading by using the theories of misappropriation, temporary insider, and tippee liability.

The misappropriation theory generally refers to an individual who takes confidential material nonpublic information from an entity in which that individual occupies a position of trust and confidence.[5] The temporary insider refers to certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer or consultant working for the corporation. These outsiders may become fiduciaries of the shareholders.[6] Both of these theories are relatively new, but have been accepted by the courts as valid theories for proving an insider trading case.

Yet another area of expansion of defining insider trading concerns tippee liability. When one party, the "tipper," provides inside information to another, the "tippee," the tippee will, according to the present status of the law, be liable if he knew or should have known that the information he received was material nonpublic information gained in breach of a fiduciary duty.[7] Because of these new theories that have been accepted by the courts,[8] the laws concerning insider trading have been in a continual state of development, and apparently there has been misunderstanding about exactly what conduct constitutes insider trading.

III. Scope of the Problem

To the best of our knowledge, prior to our study, no research had been done to evaluate the public's or even a segment of the public's understanding and application of insider trading laws. According to a recent survey, 65% of those polled believe that "the stock market is controlled by the large institutional investors in such a way that the small investor doesn't stand a chance."[9] While one poll indicated 71% of American adults believed insider trading should be illegal,[10] another poll indicated 70% of American adults believe that insider trading is common among investment professionals.[11] It may be noted that the majority of the cases alleging insider trading have been brought under one or more of the three theories outlined above rather than under the traditional theory.[12]

We hypothesized that most people may understand insider trading as it applies to traditional corporate insiders (i.e., officers and directors), but we believed there is a lack of understanding of the law with respect to the misappropriation theory, temporary insider theory, or the tipper-tippee theory. We speculated that to most people, including the so-called "market professionals," the laws concerning insider trading are murky, and either not understood or misunderstood.[13]

IV. The Study

Our research was designed to determine the level of brokers' understanding of what conduct constitutes insider trading. The purpose of the study was to explore potential problems in understanding the current status of insider trading laws. A total of 121 brokers from brokerage firms in Charleston and Columbia, South Carolina, Atlanta, Georgia, and Charlotte, North Carolina voluntarily participated in this research study.

The study was conducted by designing a questionnaire consisting of 12 objective questions based on 10 different factual situations (See Appendix A). These 10 factual situations were based on principles derived from previously litigated cases concerning insider trading.

The questionnaire was not intended to be a unified scale, rather the questions were designed to "stand alone" in measuring insider trading. However, for the purpose of analysis of data, we have grouped questions according to the theories of potential liability discussed above. Clearly this is not the only method to measure an individual's understanding of insider trading. This is a questionnaire based on factual situations and is expected to have a high face validity that can successfully eliminate socially desirable responses by the respondents. This questionnaire provides significant preliminary data concerning brokers' understanding of insider trading. We plan to further refine the questionnaire with more questions and extend the study to a larger sample in the next several months to substantiate our findings.

Brokers who participated in our survey were identified by contacting the resident manager of brokerage firms in the cities listed above. The managers were assured of brokerage firm anonymity, and brokers were assured no attempt would be made to code scores by individual broker, or by brokerage firm. A considerable number of the firms we contacted elected not to participate in our study. The following table indicates the number of brokers and brokerage firms which voluntarily participated in the study:

TABLE I

Composition of the Sample of Broker Respondents

City	Number of Brokers Participating	Number of Brokerage Offices Participating
Charleston, SC	40	5
Charlotte, NC	33	6
Columbia, SC	36	10
Atlanta, GA	12	1
TOTAL	121	22

The survey was conducted with the help of a team of research assistants consisting of business students at the College of Charleston. Most surveys were distributed and collected on the same day. The surveys were compiled only by city and not by firm or individual. The collection of data was accomplished between April 9, 1987 and May 10, 1987, resulting in a total of 121 completed questionnaires from 15 different retail brokerage firms.

For purposes of comparison, we also administered the same questionnaire to 153 undergraduate business students at the College of Charleston. These students had never studied, on a formal basis, insider trading, and were primarily sophomore business students. Additionally, we administered the same questionnaire to 28 College of Charleston undergraduate business students who had previously studied insider trading.

V. Results

The data was analyzed to determine the mean scores and percentages of correct answers for each of the 12 questions and their total scores, as shown in Table II.

TABLE II

Mean Scores and Percentages of Correct Responses for Brokers and Students

Questions	Brokers (N=121)		Students (SIT)* (N=28)		Students (NSIT)** (N=153)	
	Mean Score	%	Mean Score	%	Mean Score	%
1	.98	98%	.92	92%	.77	77%
2	.93	93%	.92	92%	.63	63%
3	.83	83%	.92	92%	.67	67%
4	.33	33%	.64	64%	.29	29%
5	.60	60%	.82	82%	.75	75%
6	.92	92%	.96	96%	.75	75%
7	.79	79%	1.00	100%	.74	74%
8	.35	35%	.89	89%	.50	50%
9	.52	52%	.57	57%	.60	60%
10	.29	29%	.07	7%	.06	6%
11	.55	55%	.46	46%	.28	28%
12	.16	16%	.78	78%	.05	5%
TOTAL	7.30	60%	9.00	75%	6.14	51%

* Students who have previously studied insider trading.
** Students who have not previously studied insider trading.

This table provides significant information. Examining the mean total scores reveals that the total score for brokers was 60% of the possible total score on the questionnaire, while the score for the students who had previously studied insider trading was 75% and for other students 51%. The scores of the brokers ranged from a high of ten (10) correct responses (83% of the total possible score) to a low of three (3) correct responses (25% of the possible total score). Additionally, students who had studied insider trading scored higher than the brokers on eight (8) of the twelve (12) questions, while students who had not studied insider trading scored higher than the brokers on three (3) of the twelve (12) questions.

Part of the confusion that brokers have in their understanding of insider trading may be traced to their response to Question 12. This question, concerning the definition of insider trading, was the most frequently missed question in the survey. As discussed earlier, insider trading is not defined, yet 84% of the stockbrokers thought insider trading was defined in either of the federal securities laws,[14] or in the recently enacted Insider Trading Sanctions Act.

As indicated above, the questions in this survey were based on principles derived from previously litigated cases. Most of the questions could be traced to a particular theory where liability was, or was not proven. These theories of liability include traditional, misappropriation, and tipper-tippee.

Table III reflects the questions that examined the understanding of a particular theory of liability and each group's performance for that grouping of questions.

TABLE III

Mean Scores and Percentages for Brokers and Students on Theories of Insider Trading

Theory	Questions	Brokers (N=121)	Students Who Have Studied Insider Trading (N=28)	Students Who Have Not Studied Insider Trading (N=153)
		Mean/ % Correct	Mean/ % Correct	Mean/ % Correct
Traditional	1,2	1.91 (95%)	1.85 (92%)	1.40 (70%)
Misappropriation	4,6	1.25 (62%)	1.60 (80%)	1.04 (52%)
Tipper-Tippee	3,5,7, 8,9,11	3.67 (61%)	4.67 (77%)	3.56 (59%)

The results show that the brokers did slightly better than both groups of students in evaluating traditional insider trading. The traditional theory of insider trading is probably the easiest to identify, as indicated by a high mean score for all three groups. The questions presented no real legal challenge to a charge of insider trading.

The questions concerning the misappropriation theory proved to be more difficult for the brokers. Thirty-eight percent (38%) of the brokers failed to identify the insider trading violations in both misappropriation questions. Only thirty-three percent (33%) of the brokers identified the facts in Question 4 as insider trading (Table I), even though the question was derived from the highly publicized case involving the *Wall Street Journal* reporter, Foster Winans. The brokers did much worse on the two misappropriation questions than the students who had previously studied insider trading (62% compared to the students' 80%).

Tippee liability and the requirement of showing "breach of a fiduciary duty" proved to be the most difficult concept for brokers to comprehend. This is especially disturbing because this is an insider trading area that is most likely to confront brokers. The brokers responses to Questions 5, 8, and 9 indicate a lack of understanding that insider trading, as defined by the *Dirks* case, requires the inside information to have been obtained in breach of a fiduciary duty.

Question 8 was designed to test Rule 14e-3 relating to tender offers. Sixty-five percent (65%) of the brokers missed this question. This means most brokers indicated the conduct was unlawful, when in fact the conduct was lawful.

Also of significance are the results of Question 11. Forty-five percent (45%) of the brokers failed to identify the insider trading posed by Question 11 (Table II). These facts indicate the tippee ("Moe") either knew or should have known he was receiving information in breach of the duty that the insider ("Jim") owed to the issuing corporation.

The brokers' total mean score for questions concerning the tipper-tippee theory of insider trading was 3.67 (61%) [Table III]. The brokers' mean percentage score is, therefore, only 2% higher than the response of undergraduate business students who had never studied insider trading.

Question 10 highlights the problem of brokers not being aware of their potential liability when they pass false tips (act as a tipper) to others (potential tippees). This occurs when a client receives what he thinks is inside information from his broker and trades on that information. Later, the client discovers he has been misled. Seventy-one percent (71%) of the brokers indicated a client would not recover against the broker in a "false tip" situation where the broker had acted as a tipper. Clearly, under the Supreme Court case of *Bateman v. Eichler, Hill Richards Inc. v. Berner*, the client would not be barred from suing his broker.

In general, there was no difference in brokers scores when brokers from the various cities were compared to each other. However, there was a statistically significant difference in brokers performance across the cities in evaluating Question 10. The total scores on the questionnaire across the cities were also statistically significant as is indicated in Table IV.

TABLE IV

Mean Scores of Brokers by City

Variables Questions	Charleston (N=40)	Columbia (N=36)	Charlotte (N=33)	Atlanta (N=12)	F
1	.97	.97	1.00	1.00	0.39
2	.95	.94	.87	1.00	0.89
3	.75	.88	.84	.91	1.15
4	.32	.33	.36	.25	0.16
5	.55	.61	.63	.66	0.27
6	.95	.88	.90	1.00	0.70
7	.77	.88	.72	.75	1.02
8	.27	.41	.36	.41	0.63
9	.45	.58	.54	.58	0.52
10	.12	.41	.39	.25	3.41*
11	.47	.61	.63	.41	1.09
12	.17	.19	.12	.16	0.23
TOTAL	6.77	7.75	7.42	7.41	2.97**
Traditional	1.92 (96%)	1.91 (96%)	1.87 (94%)	2.00 (100%)	0.47
Misappropriation	1.27 (64%)	1.22 (61%)	1.27 (64%)	1.25 (63%)	0.07
Tipper-Tippee	3.27 (55%)	4.00 (60%)	3.75 (63%)	3.75 (63%)	0.53

* p <.01; ** p <.05

It is interesting to note 74 (61%) of the brokers indicated they were satisfied they understood the definition of insider trading. However, this group had a mean total score of 7.04 (59%) as compared to a mean total score of 7.72 (64%) for the brokers who indicated they were not satisfied with their understanding of insider trading. This means the brokers who were not satisfied with their understanding of insider trading actually did better on the survey than the brokers who were satisfied with their understanding of insider trading.

VI. Other Results

Aside from the quantitative findings of our study, the study also revealed a variety of subjective attitudes brokers displayed toward the topic of insider trading. Many brokerage offices were reluctant to participate in the study. One vice president and office manager of a participating brokerage firm indicated he did not want his brokers to attend a seminar discussing the current status of the law concerning insider trading. He further indicated that he thought the law to be unclear and would be reluctant for his brokers to discuss insider trading rules. In discussing insider trading with some brokers, it appears to them that the confusion surrounding the definition of insider trading and the parameters of the definition provide justification for not carefully studying the topic.

Another reluctant manager decided not to participate after being told the results of the survey may possibly be published. After reviewing the survey, another manager did not want that brokerage office "to be used to show that stockbrokers don't understand insider trading."

Written responses to our objective questionnaire were also interesting. One broker circled the correct response "committed insider trading," but then wrote beside the response "but will not get caught." Several brokers made written notations on the questionnaire indicating they were not familiar with the term "tippee." Another broker responded to Question 12, concerning the definition of insider trading, by adding an additional objective response to the survey: "f. don't know -- and don't need to know."

VII. Conclusion

The broker who gratuitously added, when questioned about the definition of insider trading, "don't know -- don't need to know," was partly correct. Our study reveals stockbrokers do not have a high level of understanding of the judicially created definition of insider trading as it applies to a variety of factual situations.

Students who previously studied insider trading did significantly better than brokers in the important area of tipper-tippee liability. Even the students who had never studied insider trading almost equalled the brokers' score in this area.

It is clear that brokers, and all who participate either directly or indirectly in our capital market system, need to know the rules of insider trading. Being oblivious to the application of the rules prohibiting insider trading will not only increase SEC enforcement actions,[15] but will also result in private causes

of action against individual and corporate defendants who engage in insider trading.[16]

The study indicated that in all factual situations brokers could not successfully apply the judicially created definition of insider trading. We believe that it is because of a lack of a clear definition of insider trading that a confusion exists in distinguishing lawful from unlawful conduct. One can only speculate as to other groups' understanding of the current insider trading rules.

It seems to us that a clear, concise, statutory definition of insider trading is needed. A clear, concise definition of insider trading, needs to be designed to delineate lawful from unlawful conduct. This, combined with an aggressive and comprehensive training program, should decrease the incidence of insider trading and increase investor confidence in our capital market system.

Footnotes

[1] U.S.C. Section 78 u (d)(2) (Supp. 1984).

[2] An example of the coverage being given insider trading is found in the August 25, 1986 issue of *Business Week* magazine which discusses "What Wasn't $1 Million a Year Enough." A Louis Harris poll included in the article examines, among other things, the ethical standards of various professions, to include "Wall Streeters."

[3] 445 U.S. 222 (1980)

[4] 463 U.S. 646 (1983)

[5] *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 104 S.Ct. 193 (1983).

[6] *Dirks v. Securities and Exchange Commission*, 463 U.S. 646 655 n.14 (1983).

[7] For a more complete discussion of insider trading theories used by the court see Tidwell, "Here's a Tip -- Know the Rules of Insider Trading," Summer 1987, *Sloan Management Review*, pp. 93-98.

[8] The courts and the SEC have drawn a distinction between illegal insider trading based on one of the theories discussed above, and legal trading based on public information, rumors, or speculation.

[9] *Wall Street Journal/NBC News Poll*, reported in the *Wall Street Journal*, November 21, 1986, page 11.

[10] *Associated Press/Media General Poll*, conducted January 16-24, 1987.

[11] *Wall Street Journal/NBC New Poll*, conducted on March 12, 1987.

[12] Of the fifty criminal insider-trading cases recently brought in federal court in Manhattan, New York, where the bulk of the cases arise, only one involved a corporate officer or director. In contrast, four lawyers, seven law firms employees, four investment bankers, two arbitrageurs, eleven stockbrokers, four financial printers, a police officer, a *Wall Street Journal* reporter and a dentist were charged with insider trading.

[13] The difficulty of applying the insider trading rules was described in "Murky Insider-Trading Rules Often Point to Outsiders, "*The Washington Post*, June 1, 1986, page F-1. Also see: "What's Legal -- And What's Not," *Fortune*, December 22. 1986, page 36; "Cloudy Cases: Insider Trading Law Leads to an Array of Interpretations," *Wall Street Journal*, February 19, 1987, page 31; "Demand Rises for Law Defining Insider Trading to Provide More Than a Gut Feeling as a Guide," *Wall Street Journal*, March 26, 1987, page 60.

[14] The 1933 Securities Act and the 1934 Securities Exchange Act.

[15] Since 1981, the Securities and Exchange Commission has brought 125 insider trading cases, as compared with 77 during the previous 47 years.

[16] See for example: *Litton Industries, Inc. v. Lehman Brothers Kuhn Loeb, Inc.*, 86 CIV 6447 (JMC) (S.D.N.Y.); *Anheuser-Busch v. Thayer*, et al., CA3-85-0794-R (N.D. Texas).

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APPENDIX A

This is a study to determine different groups' understanding of insider trading.

We would appreciate you taking a few minutes to respond to the attached questions relating to insider trading. Simply mark your response to each of the hypothetical situations by circling the choice you believe to be correct.

To ensure anonymity, please do not identify yourself or make any identifying marks. After completing this questionnaire, please return it to the student who distributed the questionnaire.

If you have any questions concerning this survey or the topic of insider trading, please feel free to contact Professor Gary Tidwell at the College of Charleston (792-7832).

Your assistance is greatly appreciated.

Sincerely yours,

Abdul Aziz
Assistant Professor of
Business Administration

Gary L. Tidwell
Associate Professor of
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smb

REGISTERED REPRESENTATIVE QUESTIONS

Sam, the president of ABC Company, learns his company is going to acquire (by making a tender offer) XYZ Corporation. This information has not yet been publicly announced. Sam purchases stock in XYZ corporation.

1. This is:

   a. illegal insider trading
   b. not illegal insider trading

Sam's confidential secretary, Mary, makes $17,500 a year and needs money to send her 18 year old son to college. From the confidential correspondence that she types for Sam, Mary is able to deduce that ABC Company is going to purchase XYZ Corporation. Based on this information, she purchases stock in ABC Corporation.

2. This is:

   a. illegal insider trading
   b. not illegal insider trading

Bill, a friend of Jane, who often advises Jane concerning the purchase of stock, calls Jane. Bill tells Jane to purchase BB, Incorporated, because he has heard "BB is about to be taken over." Although this conversation concerning a rumored takeover is really no different than many other conversations Jane has had with Bill, Jane purchases stock in BB. Subsequently BB is taken over, and Jane has doubled her investment.

3. Jane has:

   a. violated insider trading
   b. violated insider trading based on a misappropriation theory
   c. violated insider trading based on a tippee liability theory
   d. not violated insider trading

Clyde works for television Channel 01 Newsfinder as an investigative reporter. In his position as investigative reporter, Clyde learns that Ace, Inc., will be reporting massive financial losses for the unannounced quarter. Clyde is aware of employment rules of Channel 01 which prohibit using information gained in employment for personal benefit. Clyde purchases puts in Ace, Inc., prior to his news report being aired on Channel 01 and in violation of company rules.

4. Clyde has:

   a. violated insider trading laws based on the theory of tippee liability
   b. violated insider trading based on a theory of misappropriation
   c. not violated insider trading laws because he has only violated Channel 01 rules
   d. not violated insider trading laws because he owes no duty to Ace, Incorporated

Joe Lockdown is walking down Wall Street in New York City. He finds a slip of paper on the street containing material non-public information concerning CC, Incorporated. Based on the information contained on the slip of paper, Joe purchases stock in of CC, Incorporated.

5. Joe has:

    a. committed insider trading
    b. not committed insider trading

Greg is president of DD, Inc. Because Greg trusts Bob's good business judgment and because Bob has no association with DD, Inc., Greg tells Bob he needs to talk to him. Bob is "sworn to secrecy by Greg," and Bob agrees to keep the information confidential. Greg then seeks Bob's advice concerning how to disclose a huge financial loss by DD, Inc. Bob, in confidence gives Greg his best advice. Bob then buys puts on DD, Inc. Bob makes $55,000 on his investment in DD.

6. Bob has:

    a. committed insider trading
    b. not committed insider trading

Joe and Barry are friends and have had a personal friendship for many years. Joe is at a high school track meet with his wife for the purpose of watching their son's performance. Barry attends the track meet to watch his son perform. Unknown to Joe, Barry is in the bleachers behind Joe sunbathing. Joe discusses with his wife the pending takeover of DD Corporation, of which he is a member of the Board of Directors. Barry overhears their conversation and purchases stock in DD Corporation.

7. Joe has:

    a. committed insider trading
    b. not committed insider trading

8. Barry has:

    a. committed insider trading
    b. not committed insider trading

Larry is having dinner when he sees Billy, a prominent businessman and president of Big Growth, Inc. Larry and Billy do not know each other, but Larry overhears Billy say to his companion, "Our stock is going to really increase when we announce those increased corporate earnings tomorrow." Larry purchases stock in Big Growth prior to the public announcement.

9. Larry has:

    a. committed insider trading
    b. not committed insider trading

Mark is a stockbroker and represents Clint. Mark tells Clint that he has insider information concerning Forcer, Inc., and passes this information to Clint. Clint purchases Forcer stock because of the information given to him by Mark. The information is erroneous, and Clint loses $10,000. Clint sues Mark.

10. Clint will:

    a. not recover because he and Mark are guilty of insider trading
    b. not recover because Mark is guity of insider trading
    c. not recover because he is guilty of insider trading
    d. recover

Jim is a corporate executive at XYZ corporation and a golfing buddy of Moe. Jim says to Moe, "Because we are such good buddies, you should buy XYZ corporation stock. Don't ask any questions, but I just put everything I own in XYZ and you should do the same." Moe mortgages his house, borrows money, and purchases as much XYZ stock as he can afford. Subsequently, XYZ corporation is announced as being a takeover candidate. Moe liquidates his position in XYZ and makes a substantial profit.

11. On these facts, Moe:

    a. has committed insider trading
    b. has not committed insider trading because Moe did not know this was inside information
    c. has not committed insider trading because Moe was not informed of the source of Jim's information
    d. has not committed insider trading

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12. The definition of illegal insider trading is found in:

    a. the 1933 Securities Act
    b. the 1934 Securities Exchange Act
    c. the Insider Trading Sanctions Act
    d. two of the above
    e. none of the above

PLEASE PROVIDE THE FOLLOWING ADDITIONAL INFORMATION

13. Your age:

    a. under 23
    b. 23-29
    c. 30-35
    d. 36-45
    3. 46 or older

14. Number of years as a registered representative:

a. 1 or under
b. 2-3
c. 4-7
d. 8-12
e. 13 or more

15. When did you last study on a formal or a semi-formal basis the topic of insider trading?

a. less than one month ago
b. 1-6 months ago
c. 7-24 months ago
d. more than 24 months ago
e. have never studied in a formal or semi-formal basis the topic of insider trading

16. How much total time would you estimate that you have spent studying insider trading since becoming a registered representative?

a. no time has been spent studying insider trading
b. 1-2 hours
c. 3-6 hours
d. 7-12 hours
e. greater than 12 hours

17. Are you satisfied that you understand the definition of insider trading?

a. yes
b. no

Answers

A 1. Clearly this is illegal insider trading. Sam breached a fiduciary duty to the shareholders of ABC Corporation by purchasing stock in XYZ. Sam's decision to purchase was based on material, nonpublic information that was gained in breach of his fiduciary duty to ABC.

A 2. For the same reason stated in number 1, this is also illegal. Mary also owes a fiduciary duty to ABC Corporation , and she has violated federal securities laws.

D 3. This is just a rumor and there are no facts available to show this is inside information. It is perfectly legal to invest based on a rumor or speculation, provided the rumor isn't converted into insider information.

B 4. This illustrates the misappropriation theory utilized by the Court in United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986). The United States Supreme Court decided on December 15, 1986 to review the Second Circuit's decision in this case. Here, as in the Carpenter case, there has been a theft of information from the employer.

B 5. Joe is not guilty of insider trading because no duty has been breached.

A 6. This illustrates the confidential relationship that the court outline in United States v. Thomas C. Reed, 601 F. Supp. 685 (S.D.N.Y. 1985).

B 7. This is somewhat analogous to the Switzer case where the court found neither party guilty of insider trading. SEC v. Switzer, 590 F. Supp. 756, 766 (W.D. Okla. 1984). Joe's action may constitute a somewhat careless breach of the duty of confidentiality, but these facts do not show Joe breached a fiduciary duty for personal benefit by talking to his wife.

B 8. These facts involve information involving a tender offer. However, this is not a violation of Rule 14e-3 (17 C.F.R. Section 240 14e-3) because there is no showing that Barry knows or has reason to know that the information is nonpublic. This is somewhat analogous to the Switzer case where the court found neither party guilty of insider trading. SEC v. Switzer, 590 F. Supp. 756, 766 (W.D. Okla. 1984). However, the Switzer case involved an alleged violation of Section 10b-5 and not rule 14e-3.

B 9. This is not a violation because there is no benefit to Billy as is required by Dirks v. Securities and Exchange Commission, 463 U.S. 646 (1983).

D 10. This is a false tip situation and recovery is allowed. Bateman Eichler, Hill Richards, Inv. vs. Berner, 105 S. Ct. 2622 (1985).

A 11. This is a tippee liability case where Moe either knew or should have known this was insider information, Dirks v. Securities and Exchange Commission, 463 U.S. 646, 660 (1983).

E 12. Insider trading is not defined by any of these federal statutes.

Senator RIEGLE. Thank you. I appreciate that and it's useful for us to have this information.

Have you yet had a chance to take a look at our proposal in detail or are you seeing it for the first time today?

Mr. TIDWELL. I received it on Tuesday of this week, Senator.

Senator RIEGLE. So you're wading through it at the present time?

Mr. TIDWELL. Yes, sir. I've looked at it.

Senator RIEGLE. Do you have the sense, insofar as you've been able to review it thus far, that the proposal that we have drafted here would be a substantial help in giving this clarity and definition that your findings show is needed?

Mr. TIDWELL. Yes, sir. I think that it would help in a number of respects.

First and maybe foremost—and this is really some nonstatistical data that we gathered—many brokers seem to rely on the fact that I've read articles that insider trading is murky and misunderstood or not understood and they basically sometimes use that as an excuse for not to really being concerned with insider trading.

Now, if there's a statutory law concerning the definition of insider trading, something that they can get into, I think that would encourage the brokers to become more sensitized to the issue of insider trading.

Senator RIEGLE. Very good. Well, I appreciate it. Your data will help us I think in our efforts. As you study this at greater length, if you've got any other specific thoughts or ideas for us, we'd like to have them.

Mr. TIDWELL. Yes, sir.

Senator RIEGLE. Very good. Thank you for coming.

The committee stands in adjournment.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

DEFINITION OF INSIDER TRADING

PART I

FRIDAY, JUNE 19, 1987

U.S. Senate,
Subcommittee on Securities,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The subcommittee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the subcommittee) presiding.

Present: Senators Riegle, Proxmire, Sasser, Shelby, Wirth, Armstrong, D'Amato, Hecht, and Bond.

OPENING STATEMENT OF SENATOR RIEGLE

Senator Riegle. I think what I'm going to do because, Mr. Cox, you represent an independent agency, I think I may have you appear separately, if that's agreeable. So I may have you just wait, Mr. Moore, and then have you come up after Mr. Cox has had the chance to testify.

Today we are holding our second hearing on legislation that Senator D'Amato and I introduced on Wednesday to clarify and codify the law on insider trading.

This proposal is the product of 3 months of hard work by a group of top securities lawyers. They were carefully chosen not only on the basis of their professional competence but also because of the variety of viewpoints that they represent.

The need for legislation in this area has been recognized by prosecutors such as Department of Justice attorney Rudolph Giuliani, as well as a great number of people in the securities industry. One might have thought that these two parties would not be able to agree on this subject. Yet the Securities Industry Association has taken the position that "criminal use of material nonpublic information should be defined by Congress to specify conduct that is subject to criminal sanctions."

Similarly, a group representing Morgan Stanley, First Boston, and Goldman Sachs has taken the position that "Current law of insider trading is at best confusing and at worst ineffective in prohibiting the misuse of confidential information in trading in our national securities markets."

They correctly point out that the "insider trading" law has been developed by the courts under general antifraud provisions. There is currently no statute which deals specifically with the subject of misuse of information in trading.

The Capital Markets Groups specifically recommends that a special statute should be enacted separate and apart from the general antifraud provisions of the Federal securities law to deal with the subject of trading on the basis of nonpublic information.

The details of the statute should be worked out by securities professionals who are familiar with the workings of the securities industry and who understand how to craft a statute which will not interfere with healthy and desirable market activity.

I think that is precisely what we are attempting to do here together with a group of extremely sophisticated securities lawyers, who as I say, represent all points of view around this issue.

Separately, on April 22 of this year, U.S. Attorney Rudolph Giuliani testified that he thought that a definition of insider trading would have real value from the point of law enforcement and putting an end to some of these practices. Specifically, he stated, "That if there was a clear, precise definition of it enacted by Congress, it could help to end a lot of the irrelevant debate about whether insider trading or what forms of insider trading actually constitute crimes."

This need for clarity in the law was further highlighted in our Wednesday hearing by Prof. Gary Tidwell, who shared with us the results of his study surveying the present level of broker comprehension on insider trading. His results indicated substantial confusion among brokers in applying current law and he found that "even students who have never studied insider trading almost equalled the brokers' score in that area."

Of additional note was his finding that those brokers who indicated that they were comfortable with their understanding of insider trading law scored worse than the brokers who felt that they could use more training.

Professor Tidwell concluded the study indicated that in all factual situations surveyed brokers could not successfully apply the judicially created definitions of insider trading.

He stated his belief that:

> It is because of a lack of clear definition of insider trading that a confusion exists in distinguishing lawful from unlawful conduct. Therefore, it seems to us that a clear, concise statutory definition of insider trading is needed.

So far, the official position of the administration and the Commission on the need for statutory definition has been unclear and I'm frank to say I find it difficult to understand this hesitancy when you have this very broad appeal from the professional community to move into this area and nail down the law in ways that not only would help us avoid illegal activity but when it occurs to be able to prosecute it aggressively and punish people appropriately.

I hope that in your statement today, Commissioner Cox, that you will testify that the Commission is determined to present in the near future its own proposal for a statutory definition of insider trading. I applaud this initiative. Given the time that the Government has already had to consider this issue, I would request that the SEC get back to us within 30 days, by July 20, 1987, with a specific proposal so that we are able to move ahead in this legislative year, given all the other things that we have to deal with.

So with that as an opening comment, Mr. Cox, we are delighted to welcome you as a commissioner of the Securities and Exchange Commission. You serve there at a very interesting and challenging time, to say the least. We appreciate your service and we would like to hear from you now.

STATEMENT OF CHARLES COX, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY GARY LYNCH, DIRECTOR, DIVISION OF ENFORCEMENT; AND DAN GOELZER, GENERAL COUNSEL, SEC

Mr. Cox. Thank you, Chairman Riegle. I am accompanied today by Gary Lynch, Director of the Division of Enforcement; and Dan Goelzer, general counsel of the SEC.

The Securities and Exchange Commission appreciates this opportunity to testify before you on the subject of insider trading. In particular, you have asked us to address the provisions of S. 1380, the Insider Trading Proscriptions Act of 1987, which would add a new section 16(A) to the Securities and Exchange Act of 1934. I will comment specifically on this bill and more generally on the subject of a statutory definition.

I request that my written testimony delivered to this subcommittee earlier be included in the record.

Senator Riegle. We will include it in the record.

COMMISSION WOULD SUPPORT A DEFINITION OF INSIDER TRADING

Mr. Cox. The Commission believes it is appropriate to explicitly define insider trading and could support a definition. In the past, the Commission has stated that a definition of insider trading is unnecessary. Development of the law on a case-by-case basis has been viable. Commission enforcement efforts have not been impeded, nor have recent widely publicized cases involved theories of liability which are novel or innovative.

Although the Commission could support an appropriate definition of insider trading, the Commission does not support this bill in its present form. I will briefly summarize the areas in which the Commission believes that this bill lacks needed flexibility and could impede government enforcement action.

Section 16A(b) contains the general definition and proscription of insider trading. The first subsection is a good summary of current law standards. However, the second subsection alters the current relationship between trading while in possession of inside information and trading on the basis of that information.

In the case of individuals, the bill presumes that the two are indistinguishable, although this presumption can apparently be overcome.

In the case of firms, however, the bill creates a defense which is different from that available under current Rule 14e-3. The bill changes the role of firms' procedures in providing a defense against insider trading charges. Neither of these provisions relating possession to use accurately summarizes current law.

Section 16A(c) covers wrongful communication of information. It removes from the requirements for tipper liability the so-called personal benefit test which has been troublesome in some cases.

However, this section may limit the liability of tippers, because it suggests that a tipper is required to know that there will be a resulting trade and that the resulting trade would violate the law.

Section 16A(c) also deals with communications by bidders or others proposing deals and exempts from liability certain communications involving coordinated purchases. It is not clear whether this language does, or is intended to, alter current law as expressed in rule 14e-3; nor is it clear how these provisions would relate to the duties of groups under the current ownership reporting requirements in section 13(d).

Section 16A(d) defines the scope of derivative liability under this section. It uses concepts similar to those already in section 20(a), but it is not clear whether the standards are different. The Commission does not believe there should be different standards for derivative liability.

Finally, section 16A(f), covering private rights of action, expands insider trading liability by allowing recovery by traders for a tipper's breach of a duty not owed to them. However, this subsection may not allow recovery currently being sought in cases against insider traders by bidders who allege that unlawful trading increased the price they were required to pay.

This brief summary of critical remarks is not meant to minimize the value of this bill. The Commission greatly appreciates the thoughtful work of the authors. The Commission believes that an insider trading definition could be valuable, and it will shortly present its own definition. We expect to benefit from the efforts of others, and we believe that these hearings are an important and constructive step in establishing the groundwork for a workable definition of insider trading.

I would also add, Chairman Riegle, you requested that, if we're formulating our definition we submit it by July 20. Conferring with the staff involved, we were quite sure that we could do a good job in 6 weeks, which is a little longer than July 20. I would request the additional time, please.

[The complete prepared statement of Charles C. Cox follows:]

STATEMENT OF CHARLES C. COX,
COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION,
BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

CONCERNING LEGISLATION TO DEFINE INSIDER TRADING

June 19, 1987

Chairman Riegle and Members of the Subcommittee:

The Securities and Exchange Commission is pleased to testify on the subject of a statutory definition of insider trading under the federal securities laws. In particular, the Commission has been requested to address the approach adopted in S. 1380, "The Insider Trading Proscriptions Act of 1987." This statement presents the Commission's views on a statutory definition in general, as well as more specific comments on the provisions of S. 1380.

The Commission could support a definition that preserved its authority and flexibility, although the Commission does not believe a statutory definition is necessary for the continued success of its enforcement program. The Commission does not recommend adoption of S. 1380 in its present form because it could impede government enforcement actions. Therefore, the Commission has determined to present in the near future its own proposal for a statutory definition of insider trading.

I. BACKGROUND

Since the Commission's decision in Cady, Roberts & Co., 40 S.E.C. 907 (1961), insider trading cases have generally been brought under the antifraud provisions of the federal securities laws, most notably Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. Over the years, the Commission and the courts, on a case-by-case basis, have developed the law governing this misconduct. The Commission has generally found this approach a viable one.

Recently, considerable interest has been expressed in a statutory definition of insider trading, apparently in response to numerous highly-publicized cases, and to the Supreme Court's grant of certiorari in a criminal insider trading case. 1/

1/ United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), cert. granted, 107 S. Ct. 666 (1986). In Carpenter, the defendants were criminally convicted for, among other things,

(Footnote Continued)

Several groups, including the American Bar Association Task Force on Regulation of Insider Trading, and the New York Stock Exchange, have considered definitions of insider trading. The ABA Task Force has developed two alternative proposals, and Senator D'Amato has introduced two statutory definitions drawn from these proposals. 2/ Additionally, a committee of the Securities Industry Association has studied the issue. While it has not offered its own proposal for a definition, it has recommended that the organization cooperate with other groups to encourage a definition. 3/

Proponents of a statutory definition assert several reasons why a definition is necessary. Their central focus is an alleged lack of clarity that they contend is a result of the case-by-case development of the law of insider trading. They also suggest that Supreme Court decisions in two leading insider trading cases, Chiarella v. United States 4/ and Dirks v. SEC, 5/ have

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1/ (Continued footnote)

securities fraud, based on their trading in advance of articles to be published in the "Heard on the Street" column of the Wall Street Journal. Defendant R. Foster Winans, one of the co-authors of the column, misappropriated confidential information regarding the subject and timing of these articles and secretly relayed it to the other defendants, some of whom were market professionals, who used the information to trade securities, profiting from the anticipated market movement in reaction to the articles.

While many of the securities law issues raised by defendants in the Supreme Court specifically relate to the particular facts of the case, the Court's opinion will probably have significance for the law of insider trading generally. Oral argument in Carpenter is to be heard during the Court's October 1987 term. The Commission filed amicus briefs in both the district court and the court of appeals and its Office of the General Counsel is assisting the Solicitor General's Office before the Supreme Court.

2/ S. 230, S. 231.

3/ Report by the Trading Practices Committee to the Chairman of the Securities Industry Association at 10-11 (March 25, 1987).

4/ 445 U.S. 222 (1980).

5/ 463 U.S. 646 (1983).

created gaps in the regulation of insider trading. Additionally, in light of the grant of certiorari in United States v. Carpenter, some have suggested that it is uncertain whether the "misappropriation theory" will ultimately be upheld by the courts. 6/ If the misappropriation theory is struck down there would be "a large and illogical loophole in the securities law." 7/ Proponents of a definition thus contend that a statutory provision is needed to provide certainty and clarity in the law. 8/

6/ Under the "misappropriation theory," courts have held that "one who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates Section 10(b) and Rule 10b-5." SEC v. Materia, 745 F.2d 197, 203 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985). See also United States v. Newman, 664 F.2d 12 (2d Cir. 1981), aff'd after remand, 722 F.2d 729 (2d Cir.), cert denied, 464 U.S. 863 (1983); H.R. Rep. No. 355, 98th Cong., 1st Sess. 4-5 & n.8, 13 & n.20 (1983). The misappropriation theory was endorsed by the four Justices in Chiarella who addressed its merits. See 445 U.S. at 239 (Brennan, J., concurring in the judgment); id. at 240 (Burger, C.J., dissenting); id. at 245 (Blackmun, J., joined by Marshall, J., dissenting). The other Justices found it inappropriate to address the validity of the misappropriation theory in Chiarella because the theory had not been presented to the jury. Subsequently, the Supreme Court has twice suggested that trading on "misappropriate[d] or illegally obtain[ed] information" constitutes a violation of Rule 10b-5. Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 313 n.22 (1985); Dirks v. SEC, 463 U.S. at 665.

The misappropriation theory has been applied in numerous recent cases against those who have used purloined information to profit from securities trading. See, e.g., SEC v. Siegel, No. 87 Civ. 0963 (S.D.N.Y. Feb. 13, 1987); SEC v. Boesky, No. 86 Civ. 8767 (S.D.N.Y. Nov. 14, 1986); SEC v. Tome, 638 F. Supp. 396 (S.D.N.Y. 1986), appeal pending, No. 86-6192(L) (2d Cir.); SEC v. Levine, No. 86 Civ. 3726 (S.D.N.Y. June 5, 1986); SEC v. Gaspar, [1984-85] Fed. Sec. L. Rep. (CCH) ¶ 92,004 (S.D.N.Y. 1985); SEC v. Musella, 578 F. Supp. 425 (S.D.N.Y. 1984).

7/ Brief for the United States in Carpenter v. United States (S. Ct.) at 41.

8/ See generally Report of Task Force on Regulation of Insider Trading, Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act 1934, 41 Bus Law. 223 (Nov. 1985); Committee on Criminal Law of the Association of

(Footnote Continued)

The subject of a definition was specifically considered during Congressional deliberations over the legislation that became the Insider Trading Sanctions Act of 1984 (ITSA). At that time, Congress was urged to enact a definition of insider trading for purposes of the ITSA. Proponents argued that judicial decisions did not provide clear guidance as to acceptable conduct and that the case-by-case approach was not appropriate in light of the special penalties that would be imposed under ITSA. 9/ The Commission opposed a definition, urging that the law was sufficiently clear in most cases to provide guidance as to prohibited transactions. The Commission noted that the flexibility of the case-by-case approach avoided freezing into law either a definition that was too broad or one that was too narrow. Further, the Commission emphasized that a statutory definition would necessarily introduce new terms and concepts that would need to be resolved in future litigation, and thus would create new uncertainties in the law. 10/ Congress ultimately determined not to include a definition of insider trading in the ITSA.

The Commission continues to have some of the same concerns about a statutory definition that it had when Congress considered ITSA and believes that a definition is not, at present, necessary for the continued success of the Commission's enforcement program. Since 1981, the Commission has brought 129 insider trading cases, as compared to 77 during the prior 47 years. During fiscal 1986,

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8/ (Continued footnote)

of the Bar of the City of New York, Federal Criminal Liability for Insider Trading of Securities at 3-4 (Dec. 1986); Hearing Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce, 99th Cong., 2d Sess. 62 (1986) (Testimony of George Ball); Hearing Before the Subcomm. on Securities of the Senate Banking, Housing and Urban Affairs Comm., 100th Cong. 1st Sess. (Feb. 24, 1987) (Testimony of Harvey L. Pitt).

9/ H.R. Rep. No. 355, 98th Cong. 1st Sess. 13 (1983).

10/ Insider Trading Sanctions and SEC Enforcement Legislation: Hearings Before the Subcomm. on Telecommunications, Consumer Protection and Finance of the House Comm. on Energy and Commerce, 98th Cong. 1st Sess. 92, 98-99 (1983) (Letter of John S.R. Shad, Chairman, Securities and Exchange Commission, to Chairman Timothy E. Wirth).

the Commission brought 30 insider trading cases, 11/ as compared to 20 cases in 1985. Moreover, the cases instituted in fiscal 1986 and thus far in fiscal 1987 include many of the largest and most significant cases in the Commission's history. 12/

Ironically, the Commission's success in recent, highly-publicized enforcement actions appears to be one of the factors that has generated interest in a statutory definition. The interest has emerged despite the fact that the most publicized of the Commission's recent insider trading cases against Messrs. Boesky, Levine, Siegel, and others have not involved any novel or innovative applications of insider trading law, and have relied on theories that are far from the areas of uncertainty that some critics point to as a rationale for a statutory definition of insider trading.

Nevertheless, the Commission could support an appropriate statutory definition of insider trading that preserves the Commission's authority under existing law and provides guidance and flexibility. The Commission appreciates the efforts of the groups that have drafted legislative proposals, and intends to forward to the Congress its own proposal for a statutory definition of insider trading. The Commission intends to incorporate into its proposal the experience gained by this Subcommittee and other groups that have dealt with these difficult issues. Thus, these hearings should be highly constructive to lay the essential groundwork and to provide a Congressional record for a definition.

II. COMMENTS ON S. 1380

At a hearing of this Subcommittee on February 24, 1987, Chairman Riegle requested Harvey Pitt to form a committee of securities law practitioners to draft a statute to define and prohibit insider trading. The Pitt Committee's work resulted in S. 1380, "The Insider Trading Proscriptions Act of 1987." Overall,

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11/ For statistical reporting purposes, the Commission classifies each enforcement action under one program area. During fiscal 1986, in addition to the 30 insider trading cases referred to in the text, there were four cases classified in other program areas that also involved allegations of insider trading.

12/ A detailed discussion of these cases was included in the Statement of Gary Lynch, Director, SEC Division of Enforcement, Before the Senate Committee on Banking, Housing, and Urban Affairs, 100th Cong. 1st Sess. (Apr. 22, 1987).

S. 1380 represents a thoughtful effort to codify the current law of insider trading, and would appear to encompass cases that the Commission has brought. There is much the Commission could endorse in this proposal, which the Commission believes is a significant and positive effort to draft a statutory definition. Nevertheless, the Commission has concerns about several provisions of S. 1380, and the accompanying "Brief Explanatory Memorandum" prepared by the Pitt Committee. In particular, certain portions of the bill could, if enacted, impede the prosecution of enforcement cases. Among other concerns we have with the explanatory memorandum, it is inconsistent in a number of respects with the bill and raises additional ambiguities. These concerns, as well as other comments on the bill, are discussed below. Should the Subcommittee determine to go forward at this time with S. 1380, the Commission would appreciate the opportunity to provide further comments on the proposed legislation and on the accompanying explanatory memorandum.

A. General Scope of Proposed Section 16A

S. 1380 would address insider trading by, in large part, codifying existing law. New Section 16A of the Securities Exchange Act would prohibit the use of inside information that is "wrongfully" obtained or used, and would broadly define such "wrongful" conduct. Thus, it would adopt and build upon the existing case law regarding both traditional insider trading and the misappropriation theory.

This approach would provide continuity in the law. The proposal would reflect Congressional approval of the principles underlying the current insider trading law and provide an express statutory basis for enforcement actions. The proposal would continue to leave to the Commission and the courts the development of certain key concepts, such as "nonpublic," and "material" information, and the nature of the duties and confidential relationships, the breach of which would be actionable. As a result, however, the proposal also would retain many aspects of current law that have been criticized as uncertain. 13/ For example, actions could be based upon the breach of a variety of relationships of trust and confidence and the existence of such a relationship would have to be litigated on a case-by-case basis.

13/ See Committee on Criminal Law of the Association of the Bar of the City of New York, Federal Criminal Liability for Insider Trading of Securities at 27-28 (Dec. 1986).

Proposed Section 16A would provide the exclusive basis on which to institute insider trading cases. Section 16A(g) states that the new section shall provide the "exclusive standards" for addressing the wrongful use or communication of material, nonpublic information in connection with the purchase or sale of securities. Thus, Rule 10b-5 and Rule 14e-3 would no longer be available for prosecution of insider trading cases. The bill states that it would not affect other requirements of law, such as the application of Section 10(b) and Rule 10b-5 to other types of fraudulent conduct -- for example, manipulation or the dissemination of false information. Nor should it. However, the exclusivity provision may enable defendants to argue that other types of conduct relating to the trading of securities, which the Commission would seek to prosecute under different provisions of the securities laws, are not unlawful because they do not fall within the proscriptions of new Section 16A.

B. Specific Provisions of Proposed Section 16A

1. Subsection (b): Wrongful Use of Material, Nonpublic Information

Trading -- Section 16A(b) of the bill would prohibit the use of material, nonpublic information for securities trading if the trading person knows or is reckless in not knowing that such information has been "wrongfully obtained," or if the trading would constitute a "wrongful use" of the information. "Wrongfully" is defined broadly to include theft, conversion, misappropriation, or the breach of a fiduciary, contractual, employment, personal or other relationship of trust and confidence. This definition would appear to cover all conduct that is currently covered by traditional insider trading doctrine and the misappropriation theory. 14/ It would enable the government and other plaintiffs

to continue to argue that the breach of certain relationships outside a business context may result in liability. 15/

"Use" or Possession" -- Section 16A(b)(2) creates a presumption that a natural person who has traded "while in possession of" confidential information has "used" that information. This provision apparently is intended to reflect the Commission's traditional position that trading while in possession of inside information is itself a violation. 16/ However, Section 16A(b)(2) apparently would permit a defendant to rebut this presumption.

For traders that are not individuals -- for example, a multi-service brokerage firm -- the bill provides that the presumption that any information the entity possessed was used for trading shall be overcome if the entity can prove two things. First, the entity must prove that a trade for the firm's account was not influenced by material nonpublic information in its possession. Second, it must prove that the individual effecting the trade did not know the information. Section 16A(b)(2) states that the existence and maintenance of internal procedures designed to prevent violations (e.g., Chinese Walls, restricted lists) would be relevant evidence in this respect. This exception is broader than the corresponding provision in existing Rule 14e-3, which allows a firm to defend against an insider trading charge if both the individual who made or caused the investment decision did not know the inside information, and the institution had implemented reasonble policies designed to prevent violations. 17/

The Commission believes that proposed Section 16A(b)(2) would create difficulties in proving cases against individual defendants who claimed that their trading was based on factors other than the material, nonpublic information they possessed. In many situations, individuals who actually traded on the basis of inside information will try to craft arguments that they

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14/ As noted, Section 16A(b)(1), following the standards of existing case law, would prohibit the use of confidential information obtained by a breach of any "contractual [or] employment" relationship. Thus, the explanatory memorandum is wrong in suggesting that the bill would preclude prosecution under the theory of United States v. Carpenter, 791 F.2d 1024 (2d. Cir.), cert. granted, 107 S. Ct. 666 (1986). The theory of that case was that defendant Winans, a Wall Street Journal reporter, misappropriated confidential information in breach of a duty of confidentiality owed to his employer.

15/ However, the enumerated activities that would constitute wrongful use (i.e., conversion, etc.) are circumscribed by the word "only". Thus, although the provision is broad, the insertion of the word "only" could reduce Commission flexibility in bringing future actions.

16/ See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). Accord, Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236 (1974).

17/ Also, unlike Rule 14e-3, Section 16A(b)(2) would provide an affirmative defense for all insider trading, not just that relating to tender offers.

traded for other reasons. Indeed, the Commission has encountered such behavior by insider traders who have attempted to create post hoc rationalizations based on newspaper articles and research reports. Such conduct could have the effect of greatly increasing the Commission's evidentiary burden in insider trading cases. Accordingly, an irrebuttable presumption would be preferable as a law enforcement matter. The Commission could use rulemaking or exemptive authority to exempt from the Section's proscriptions individuals who present situations where liability would be inappropriate.

Moreover, with respect to institutional traders, it is unclear what effect Section 16A(b)(2) would have on the significance of a firm's internal procedures designed to prevent violations. On the one hand, the proposed test is whether the firm's employee making the trade knew or was influenced by the information, and the existence of internal procedures is not a necessary element of the defense; thus, the significance of such procedures may be diminished. On the other hand, the provision specifically states that internal procedures are relevant evidence in this regard; thus, firms may adopt procedures, believing that they will be shielded from liability.

Tippee Liability -- There is no provision in the bill expressly dealing with "tippees" -- that is, persons who trade while in possession of material nonpublic information communicated to them by others. The basis for tippee liability, therefore, must be found in the general trading prohibitions of Section 16A(b)(1).

The proposal, as drafted, confuses the scope of tippee liability by imposing an unclear mental state requirement. The Commission believes the scienter-based standard should be retained. Under current law, one who trades while in possession of material, nonpublic information, including a tippee or subtippee, is liable if the person knows or should have known that the information has been obtained in breach of a duty. 18/ One clause of Section 16A(b)(1), however, states that a trading person is liable if the person "knows or is reckless in not knowing" that inside information has been obtained wrongfully. The distinction between the standards of "recklessness in not knowing" information, and "knowing or should have known" information, introduces a distinction with unclear implications for the scope of liability. To date, the case law has developed so that a tippee will be liable if he trades on information he knew or should have known was obtained in breach of a duty.

18/ See Dirks v. SEC, 463 U.S. 646, 660 (1983).

2. Subsection (c) - Wrongful Recommendation of Securities or Communication of Material, Nonpublic Information

Tipping -- Section 16A(c)(1) would prohibit communicating material nonpublic information where the tipper knows (or is reckless in not knowing) that the tip would be used for illegal trading, and trading does occur. This provision would be an improvement to the current law by eliminating the requirement that the tipper anticipate a "personal benefit" from the tip. 19/

On the other hand, the language of this subsection would appear to limit tipper liability to those cases where the tipper knew (or was reckless in not knowing) that the tippee would trade and that the trade "would violate" the law, a change from the current law. This language suggests that tippers may be able to insulate themselves from liability by tipping in such a manner that their tippees do not have the requisite knowledge to violate the law -- for example, by giving a vague tip or simply a recommmendation to buy or sell. 20/ It is not clear that this result is intended. The explanatory memorandum states (at p.10):

> [W]hen proceeding against a tipper, it is clear that, in addition to the elements of tipper liability, as to the tippee, the government must establish simply that he or she traded after receiving the information; this provision would not require the government to prove that the tippee knew that the communication, and therefore his trade, was wrongful, to sustain the action against the tipper.

Notwithstanding this explanation, the statutory language in Section 16A(c)(1) -- requiring knowledge that the tippee would trade and that the trade "would violate" the law -- could be interpreted to require that the tipper's liability depend on both the tipper's knowledge and the tippee's liability.

The liability of a tipper should not turn on whether the tipper knew the tippee would trade or on whether all the elements of the violation can be proven against the tippee. The preferable approach is the existing law standard. Tippers are liable if, in breach of a duty, they communicate material, nonpublic information

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19/ See Dirks v. SEC, 463 U.S. at 662.

20/ It is unclear whether the clause of Section 16A(b)(1) prohibiting trading "if the purchase or sale would constitute a wrongful use of [material nonpublic] information," would reach a trade by a tippee who was unaware that the tipper had breached a duty.

which results in a trade, regardless of whether the tippee also violated the law. In any event, the ambiguity created by the conflict between the statutory language of Section 16A(c)(1) and the explanatory statement should be resolved.

Communications by Tender Offerors -- Section 16A(c)(2) deals with the issue of tender offer bidders communicating their plans to others before publicly disclosing their intentions. Under existing Rule 14e-3, it is unlawful for anyone who learns from the bidder of material nonpublic information concerning a tender offer to trade, even if the bidder intended the recipient of the information to trade. Since the bill contemplates that Rule 14e-3 will be repealed, it creates a statutory substitute for this facet of the rule.

Under Section 16A(c)(2), a person planning an acquisition or disposition of an issuer would be prohibited from communicating those plans to others for the purpose of influencing or encouraging trading in that issuer's shares, unless the recipients of the information are acting on behalf of, or as part of a group (within the meaning of Section 13(d)(3) of the 1934 Act) with the person planning the transaction. This provision is apparently intended to enable bidders to direct those with whom they are acting to effectuate the transaction; the bidders could not tell others of a planned tender offer simply to put the issuer in play or to encourage purchases of the issuer's shares.

The implications of this provision are unclear. In the Commission's view, the provision would require substantial study to clarify its scope and intent.

3. Subsection (d) - Derivative Liability

Section 16A(d) would provide that an employer or controlling person is derivatively liable only if it has participated in, or directly or indirectly induced the violation. The scope of this provision is uncertain because the courts would need to resolve what types of conduct constituted "participation" or "inducement" of violations. Moreover, it appears that this provision would narrow the liability of employers and controlling persons.

Under existing Section 20(a) of the Securities Exchange Act, a controlling person is not liable if it acted in good faith and did not directly or indirectly induce the violation. Unlike the proposed Section 16A(d), Section 20(a) does not require that an employer or controlling person "participate in" the violation. Further, under the judicial doctrine of respondeat superior, an employer currently is liable for the conduct of its employees to

the extent that they cause injury in the course of their employment. 21/

If this provision is designed to change existing standards of derivative liability for insider trading, it is unclear why a change is necessary. If the provision is designed to codify existing law, it is superfluous. Section 20(a) would be applicable to violations of proposed Section 16A.

The Commission notes that it cannot seek penalties under the Insider Trading Sanctions Act for controlling persons under Section 20(a). 22/ This limitation was included in ITSA only because it was thought inappropriate to subject to treble damage penalties a control person who neither shared in the profits of the inside trader nor tipped the trader. 23/ ITSA did not change and was not intended to change the law regarding liability of employees or controlling persons generally. 24/

4. Subsection (e) - Commission Rulemaking Authority

Section 16A(e) would give the Commission rulemaking authority to implement its provisions "by rules consistent with the provisions of this section." It is unclear why the phrase "consistent with the provisions of this section" has been inserted, since it is redundant. The Section also would give the Commission exemptive authority to exempt, by rule or order, persons and transactions from any or all of its provisions. The explanatory memorandum indicates that the Commission's rulemaking authority is intended to be "channelled" by the Congressional findings in Section 16A(a). Any statutory definition should not limit the Commission's

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21/ Although the courts are split on the issue, a majority have held that the Section 20(a) controlling person provision is not the sole basis for derivative liability, and that the doctrine of respondeat superior is applicable to violations of the 1934 Act. The enactment of Section 16A would not necessarily affect the resolution of this issue for purposes of other violations of the 1934 Act.

22/ See Section 21(d)(2)(D).

23/ H.R. Rep. No. 355, 98th Cong. 1st Sess. 28 (1983) (letter from Chairman John S.R. Shad, Securities and Exchange Commission, to Chairman Timothy E. Wirth).

24/ H.R. Rep. 355, 98th Cong., 1st Sess. at 9-10 (1983).

broad general rulemaking authority under Section 23 of the Securities Exchange Act. Any ambiguity in proposed Section 16A(e) or the explanatory memorandum should be resolved by an express reference to the Commission's broad rulemaking authority contained in Section 23.

5. Subsection (f) - Private Rights of Action

Section 16A(f) of the bill would provide a private right of action for damages to any person who is injured by a violation of Sections 16A(b) or (c). Persons are deemed to have been injured if they have purchased or sold the affected securities contemporaneously with the transactions of the persons who have violated the law. Thus, Section 16A(f) would clarify that investors who trade in the market while insider trading is occurring may sue for damages. The Second Circuit has precluded such recovery in misappropriation cases. 25/ The Sixth Circuit has precluded recovery even in traditional insider trading cases where the plaintiffs neither dealt with the defendants nor were influenced in their trading decision by the defendants' trading. 26/ Section 16A(f) would reverse these decisions.

No other private right of action is specified. The exclusivity provision of Section 16A(g) might lead courts to conclude that the bill is intended to eliminate the right of a tender offer bidder to bring, under the federal securities laws, a private action for damages caused by insider trading. Reading Sections 16A(f) and (g) together could possibly preclude suits like Anheuser-Busch Co. v. Thayer, No. CA3-85-0794-R (N.D. Tex.) (action by bidder alleging that defendants' trading on misappropriated nonpublic information concerning the proposed transaction caused price rise in the target company's stock), and FMC Corp. v. Boesky, No. 86-C-9879 (E.D. Ill., dismissed April 16, 1987) appeal docketed, No. 87-1678 (7th Cir. April 28, 1987) (corporation alleged that it paid an additional $220 million in its share repurchase plan as a result of insider trading that increased market price of shares). Although the explanatory memorandum states that this result is not intended, defendants will argue that the two provisions preclude damages actions under the federal securities laws other than those brought by contemporaneous traders.

25/ Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d Cir. 1983), cert denied, 465 U.S. 1025 (1984).

26/ Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977).

III. CONCLUSION

The enactment of a statutory definition of insider trading is a matter of great importance to the Commission, the securities industry, and the investing public. The Commission appreciates the thoughtful contributions of the Pitt Committee to this debate.

The Commission could support an appropriate statutory definition that retained the Commission's authority and flexibility, and provided guidance to the securities industry and the investing public. The Commission has had considerable success in enforcing the law under the current approach, and therefore does not believe that a statutory definition is necessary for the continued viability of its enforcement program.

The Commission believes this Subcommittee has begun important groundwork to examine a statutory definition. S. 1380 is an excellent beginning point for this process. Nevertheless, the Commission does not recommend adoption of S. 1380 in its present form because: (1) it would alter existing law in certain respects that could impede government enforcement actions; (2) it would create additional ambiguities in the law; and (3) it would fail to resolve certain ambiguities that could be addressed in legislation. Instead, the Commission will offer its own proposal in the near future. 27/

27/ The views in this statement do not necessarily reflect the views of the Administration.

Senator RIEGLE. First of all, let me say that I welcome your response and I welcome the constructive nature in which it's put. These are very complex issues and they are not issues easily settled and it's very important that we have an exchange going back and forth as we work our way to a definition that is sound and that will do the job.

So in an area of the law that is as arcane as we find here, I think the time that it takes to do it carefully and properly and step by step is appropriate. So I am prepared to adjust my request to that time schedule which you think would allow you the time you need to do it fully.

Now let me ask at the same time then two things from you, if I may.

One is that I would want to make sure that you take into consideration as well the wide variety of points of view that bear on this issue because there are a number of parties at interest. That was done, as you know, with respect to the Pitt Committee, including very strong past and present SEC participation.

But I think it is very important that there be an effort made to take into account the points of view of all the parties at interest.

The other thing is, I think it's crucial that we force ourselves to work the proposal into plain English as much as that is humanly possible. So I would ask if you feel that you can do those two things as well.

Mr. COX. We certainly intend to take full account of the efforts that have gone on so far—the Pitt Committee—and of others who have been involved with working on definitions.

Furthermore, there was a real effort made by the Commission to come up with a statutory definition at the time the Insider Trading Sanctions Act was considered.

So we have some experience in those attempts. We will take everyone's work into account.

On the second point, certainly the clearer and the more plain the English, the better. But there has to be some balance between a workable statute and plain English. I suggest that certainly the Pitt Committee's proposal that we have before us today is not something that an average person on the street could flip open and come away with, "Oh, yes, now I understand this." I think that that's the result of the complexity of the issue, as you pointed out.

Senator RIEGLE. Now as I look at the calendar here, that would give us a delivery date of August 3. Would that be a workable date and could we count on that?

Mr. COX. We vowed we would have a definition in 6 weeks, so if that's 6 weeks I'll say yes.

Senator RIEGLE. All right. Very good. The reason that I think it's important that we pin that down is that, as you know, we've got a very crowded legislative calendar and there are a number of contentious issues and I think in order to be in a position to move through the legislative process here, through the markup in the committee and get ourselves scheduled on the floor in this session, we need to stay on that kind of a timetable. So I appreciate your commitment to it and we look forward to having it on August 3.

With that, I'm going to withhold questions for the moment and ask my colleague, Senator Proxmire, if he has any questions he would like to raise at this point.

Senator PROXMIRE. Thank you, Mr. Chairman.

Mr. Cox, are you the Acting Chairman of the SEC now?

Mr. COX. Yes, Senator, I am.

Senator PROXMIRE. And do you speak for the Commission?

Mr. COX. Yes, sir.

Senator PROXMIRE. Did the Commission discuss this particular issue as a body?

Mr. COX. Yes, sir.

Senator PROXMIRE. Was there a vote taken on it?

Mr. COX. Yes, sir.

Senator PROXMIRE. Was the vote unanimous?

Mr. COX. I guess I would prefer not to go into votes taken in a closed meeting if I could avoid it. I would be willing to communicate that.

Senator PROXMIRE. I'm not asking you who voted and how. I was just asking you whether this was a unanimous decision or there was a difference of opinion. It would be helpful to the committee to know that.

Mr. COX. There was a difference of opinion on timing. I believe that all of the Commissioners agree that they could support an appropriate statutory definition.

Senator PROXMIRE. But was there a difference of opinion as to whether or not the Pitt proposal was satisfactory?

Mr. COX. No, Senator Proxmire, there was not.

Senator PROXMIRE. There was unanimity on that?

Mr. COX. Yes.

Senator PROXMIRE. Did you consult with Mr. Lynch, the head of the Enforcement Division?

Mr. COX. We certainly did.

Senator PROXMIRE. Did he express his support for your position?

Mr. COX. Yes, I believe that he supports the Commission's statement that we do not support the Pitt proposal but that we could support a definition.

Senator PROXMIRE. Did the former chairman, Mr. Shad, play any part in this?

Mr. COX. No, Senator, he was not at the meeting.

Senator PROXMIRE. Did you discuss this in any way or was there any input from the chairman-designate, Mr. Ruder?

Mr. COX. No. The meeting took place before the announcement of Mr. Ruder's nomination.

Senator PROXMIRE. You say that the Commission will propose an alternative definition or your recommended definition within 6 weeks, is that right?

Mr. COX. Yes, sir.

Senator PROXMIRE. Are you asking this in part because you will have a new chairman on board in all likelihood by then?

Mr. COX. That was not the thought at the time since we had no idea when we would have a new chairman when we made that decision. It was really on the basis of the magnitude of the task of getting everyone together, getting a definition that we agree upon, and one that suits the enforcement program, is workable in that way, and one that doesn't leave ambiguities and so forth.

So it was really made from the basis of what we thought we could get together, work on, and get in to you folks and, as I said, the new chairman was an unknown at the time we made the decision.

Senator PROXMIRE. Did you say you would recommend a tougher definition?

Mr. COX. I said that we wanted to make sure we had one that didn't leave ambiguities or potential problems for the enforcement program. That was a basis on which we made the decision that we did not support the Pitt proposal.

SUPPORT FOR STATUTORY DEFINITION

Senator PROXMIRE. I get the impression in part from your testimony that you seem to feel you might not need a definition, but if the committee persisted and asked you for one you would give one that would at least not make the present situation any worse.

Is it the position of the Commission in general that you would be just as happy if we did nothing as far as definition is concerned?

Mr. COX. Our position is that a statutory definition is not required for the success of the enforcement program. In other words, we are not saying that if we don't have one soon the enforcement program will fall apart. We can continue our successful enforcement program. We believe that the law is clear and allows us to do that.

I think it is a policy decision on the part of the Commission that an appropriate statutory definition is desirable.

Senator PROXMIRE. But I want to know why it's desirable because you said in the first place that the Pitt recommendation is worse than present law, and that you would be better off without it. I don't mean that to demean Mr. Pitt because I have great admiration and respect for him. I think he's a very able man and he did a very hard, tough, conscientious job here.

But your position is that you would be better off without that rather than with it?

Mr. COX. Yes. I think the ambiguities in that proposal would create problems for the enforcement program.

Senator PROXMIRE. But are you confident that you can come up with a definition that will strengthen your enforcement position, and strengthen rather than weaken the position of the SEC generally with respect to insider trading?

Mr. COX. I don't think that we are looking to weaken the enforcement program.

Senator PROXMIRE. I know you're not looking to weaken it. What I'm getting at is whether there's anything positive here, anything significant that you can do to have a definition that would improve the present situation. From you, so far, I get the notion that you're fairly indifferent as to whether we have a definition as long as it's not something which would weaken the present law which you think the Pitt proposal does.

Mr. Cox. I think from the standpoint of the enforcement program, the Commission and the staff are of the view that it would continue successfully in the absence of a statutory definition.

I believe that the idea of a statutory definition is that it could be beneficial from the standpoint of clarity, from the standpoint of the perception. There are a lot of questions raised by the public about this. My personal view is that it's beneficial to get this set out in a statute. Because of the number of interests and the different viewpoints that are channeled into the decision through the Members of Congress, I believe we'll come out with something where the parameters are set according to what the public wants. That's my main desire for a statutory definition.

Senator PROXMIRE. Thank you.

Thank you, Mr. Chairman.

Senator RIEGLE. Thank you, Senator Proxmire.

Senator Hecht was here. I don't notice him at the moment. He was the first one here on the Republican side and Senators Armstrong and D'Amato came in at exactly the same time and Senator Armstrong is willing to yield to Senator D'Amato at this point.

Senator D'AMATO. Thank you, Mr. Chairman, and I thank Senator Armstrong.

I have to tell you, Commissioner, I am totally befuddled by the SEC's exact position on the issue of a definition. You seem to want it both ways.

You claim that the proposed legislation creates more loopholes. I disagree with you. I think it closes some loopholes created by the courts. Then in response to Senator Proxmire's questions, you state that the SEC has determined that a statutory definition is desirable. Which is it? We've been after you for 3 years. I'm finished beating around the bush. I don't believe you really do think that is the case. You only want a definition when pressed. I wonder how you can come to the conclusion that the present status is acceptable when the Supreme Court has indicated on at least two occasions that it's not acceptable. When you have the *Winans* case going up to the Supreme Court and a 2 to 1 decision in the appellate court which indicates that there is some vagueness in the law, especially with regard to criminal convictions combined with the decisions in the *Chiarella* case, and the *Dirks* case, it appears that the courts are crying out to Congress for a better definition.

A better definition is not necessarily going to stop crooks from being crooks. It does determine the line of misconduct and the standard of conduct with some preciseness and it seems to me when we're talking about criminal statutes and penalties that people have a right to know. You're not going to get convictions when the standard is so ambiguous that it cannot be applied by jurors beyond a reasonable doubt.

Then you come forward representing the SEC and you keep saying to us, "Oh, no, some smart lawyer is going to create a loophole to get his client off." Well, that loophole exists. Let's not kid ourselves. The Supreme Court has said it. If you've read the decision in *Dirks,* the Court essentially states this. It says as a practice the courts criticize the SEC for propounding insider trading theories on a case-by-case basis as a practice which "it views as inherently imprecise." It says it's in need of remedy because "such imprecisions prevent parties from ordering their actions in accordance with legal requirements. Unless the parties have some guidance as to where the line is between permissible and impermissible disclosures and uses" and it goes on.

Now look, is it because of pride of authorship? If it's because of pride of authorship, then please come up with a better definition. But for you to sit here and say to me—and I've had it because the SEC has been dodging the issue for 3 years—that your unclear as to what should be done, is just not a satisfactory answer.

Now a few minutes ago you said that the SEC determined that a statutory definition is desirable. Why is it desirable?

WHY SEC SUPPORTS A STATUTORY DEFINITION

Mr. Cox. I think it's desirable to set the parameters on insider trading at the point where the public wants them. I think that by coming through Congress—the Members of the Senate, the Members of the House—with a statutory definition, we'll get the kind of definition that people desire.

Senator D'Amato. Has the SEC determined that a statutory definition—because you've indicated that to Senator Proxmire—is desirable?

Mr. Cox. Yes. That is what I testified here.

Senator D'Amato. Fine. Are you going to suggest one to us or are you just going to criticize every one that comes down the pike?

Mr. Cox. Yes, Senator, I testified——

Senator D'Amato. When are you going to get it to us?

Mr. Cox. I just testified to Senator Riegle that we would submit it by August 3.

Senator D'Amato. It would take you that long? You haven't been looking into this before? You haven't been working on this? You've known about my interest in this 3 years and you're not prepared? We even discussed this issue at previous hearings?

Mr. Cox. Senator D'Amato, at the time the Insider Trading Sanctions Act was considered, the idea that there should be a statutory definition was considered. The Commission worked on it at that time. Congress made the decision not to include a definition but to get on with the Insider Trading Sanctions Act.

Senator D'Amato. We did that because we didn't get any support from the SEC with respect to a definition because we needed the ITSA sanctions more than a definition at that time. Let's be candid.

Mr. Cox. Over the time period since then, we have had a successful enforcement program. We have been at work enforcing the law.

Senator D'Amato. Don't tell me about that. That has nothing to do with the definition, whether or not there's a need for a definition as it relates to the enforcement. All right? Those are two different animals.

Now the fact of the matter is, you say you're going to develop a definition for insider trading, a statutory proposal, and submit it to us by no later than August 3?

Mr. Cox. Yes, Senator.

Senator D'Amato. Well, I'd be interested and that will be one great step forward to see whether or not that definition materializes. Thank you.

Senator Proxmire. Chairman Riegle had to step out of the room for a minute. Our next questioner will be Senator Shelby.

BURDEN OF PROOF

Senator Shelby. I want to know if you are familiar with that part of the bill regarding the burden of proof? In other words, it looks to me like a shift of the burden of proof on the criminal aspects and I was looking at what we had the other day here when Mr. Pitt was here. It says:

> For purposes of subsection (b)(1), any person who purchases or sells a security while in possession of material, non-public information relating to that security or the market therefore shall be presumed to have used that information in connection with such purchase or sale, notwithstanding the foregoing. In the case of a person other than a natural person, the presumption that such material, non-public information in that person's possession was used in connection with transactions in that security shall be overcome if such person sustains a burden of proving

so and so.

It seems to me that that brings forth some real constitutional problems in this. The burden of proof, as I understand the law—and I feel like if we're going to make public policy the law should be that the prosecution should always have the burden of proof.

Let's assume that it's a criminal proceeding and you don't take the stand. There can't be a presumption of guilt there, the presumption that somebody did so and so. I think this legislation falls in that part and I talked to Mr. Pitt about it and I don't think they are comfortable with it.

I'd like to hear what the SEC says about it. It might make your job easier, but making your job easier doesn't satisfy public policy all the time. I'd like to hear your comments on that.

Mr. Cox. Yes, Senator. First of all, I want to make it clear that I think it would be inappropriate for me to comment on criminal requirements because the SEC does not bring criminal actions. Anything on the criminal side is turned over to the Justice Department.

Senator Shelby. But you work hand-in-hand with the Justice Department?

Mr. Cox. Yes, we cooperate with the Justice Department.

Senator Shelby. The Justice Department does the prosecution but oftentimes you do the findings, right?

Mr. Cox. Right. The investigations often have been started with the SEC. But let me address this point.

Under the current law, if someone trades while in possession of material, nonpublic information, that is taken as what would violate the securities laws.

Now I think that everyone is really concerned with someone trading on the basis of that information. But let me pose the following situation: suppose that someone has a program of selling stocks, that is, sells so much per month. This is a traditional insider who then comes on material, nonpublic information. The company is doing very poorly but this isn't announced.

Well, the way the law stands, that person would be required to refrain from trading, from making this monthly sale. The presumption in the Pitt proposal is that trading while in possession of inside information means use of the information, or trading on the basis of the information.

Senator **Shelby**. Presumption means guilt, in other words, is what you're getting at, and shouldn't the presumption always be one of innocence until the prosecution—you know, the Justice Department in this case—proves its case? I mean, the judge can instruct the jury on the various aspects of the law, but I thought we had in the Constitution—it's been my understanding always—that you didn't have to become a witness against yourself, and you don't have to take the stand to rebut anything.

Mr. Cox. Well, I really don't think that that's quite the situation.

Senator **Shelby**. Well, a lot of people think so.

Mr. Cox. I think that what they're getting at is that trading in possession will be presumed to be using that information and in the Pitt proposal——

Senator **Shelby**. It might be evidence of somebody doing something, but why use a presumption when you could have constitutional problems in the legislation at its outset? Sure, it's going to make it easier for you and the Justice Department, but as I tried to point out to you, I think our criminal justice system is a lot broader and bigger than that and more important.

Mr. Cox. I would be treading into ground where I am completely uninformed on this criminal law issue. But as far as the cases that we bring, it is very important that trading in possession be the standard because we've come to numerous cases where people come up with post hoc explanations for trading. This is an example of what I'm talking about—just after, say, an employee of a law firm has been involved in a conference with top executives of a company about a takeover attempt, one of the members of that firm buys 50 call options in the stock of the target. When the person is investigated, he then says, "Well, it had nothing to do with that," and brings in a recommendation from a securities magazine 6 months hence that said stock in company "x" would be a good buy and says, "This is the basis I was trading on".

Senator **Shelby**. Why have a presumption? Why not use evidence of and let the burden of proof be set?

My time is up. Mr. Chairman, I would ask unanimous consent that my opening statement be made a part of the record.

Senator **Proxmire**. Without objection, so ordered.

[The complete prepared statement of Senator Shelby follows:]

PREPARED STATEMENT OF SENATOR SHELBY

Senator **Shelby**. Mr. Chairman, I want to commend the chairman for his continued leadership in addressing the serious problem of insider trading.

Two days ago we began our series of hearings on a proposed definition of insider trading. While I commend the members of the panel that dealt with the difficult task of attempting to develop a definition, I have some concerns which I raised at Wednesday's hearing and will do so again today.

The primary concern that I have centers around the presumption of wrongful action contained in the measure. I think that we must take a careful look to determine whether this presumption would pass constitutional due process muster.

Not only is the "use presumption" constitutionally suspect, but it would be unreasonable public policy. Every day investment bankers trade in securities about which other members of the same firm have inside information.

To assume that an illicit exchange of information occurred, and to force the burden of proof upon the accused, grants too broad of a statutory authority to the SEC. The SEC could file literally thousands of charges every day, of which very few would have validity. Each time, the accused would have to prove his innocence.

This is tantamount to charging that the accused is guilty until proven innocent.

I welcome our witnesses here today and look forward to discussing the use of this presumption with you.

Senator **Proxmire**. Senator Armstrong.

Senator **Armstrong**. Thank you, Mr. Chairman.

Mr. Cox, a moment ago you pointed out that you wanted to be cautious about speaking on matters that were beyond your competence and we appreciate that because that is a prerogative which Senators like to preserve for themselves and we are grateful to you for not trespassing on our territory.

I understand you're an economist and not a lawyer. There are a couple of good lawyers up here at the table. I don't happen to be a lawyer.

But I want to address a question to you which springs readily to mind at least to me because in real life I'm a businessman.

INSIDER TRADING DEFINITION SHOULD BE EASILY UNDERSTOOD

My question is this. Will the Commission recommend to us an insider trading definition which will be readily understood by practitioners, by people who are businessmen and women, who are buying and selling stocks?

My concern is that the present law is so ambiguous, the proposal is so ambiguous, the discussion is so ambiguous, and the court cases are so ambiguous, that in all good conscience it really is impossible at the margins for somebody to know whether they're complying with the law or not.

May I ask first, do you agree with this characterization? Second, do you think you can come up with something that would be not so technical that the average practitioners would be able to be confident of their compliance?

Mr. Cox. First, I would say the law is complicated but I think it's clear. What that means is, I think it takes some work to understand it, but once that work is put in it's clear. So that I would agree that the average person can't simply open a book and read two sentences and say, "Now I understand it."

And I agree completely that the current law of insider trading is not a little cookbook, two-sentence definition, nor is the Pitt proposal.

Now, as I said a few minutes ago, I think that simplicity is desirable but that has to be balanced with getting at the purposes of the law. And while we will try to make our proposal as clear and direct as possible, I think that, the complexities of insider trading, we're not going to be able to distill it to something where somebody can just read a couple of sentences and say, "OK, I understand it."

Senator **Armstrong**. Mr. Cox, my concern is not simplicity. That's desirable. But clarity. And there's a big difference. It's the question of certainty. I can well understand that in a complex area of the law that even practitioners, even people who are not lawyers but who are just brokers, who are just businessmen, may have to invest a substantial amount of time and effort to study to understand it. But when they get done doing that, my question is whether or not it will be clear.

I would suggest, for example, a reasonable test for that might be to take any hypothetical proposal, any suggested proposal, and take a representative group of such people—brokers, businessmen, traders, dealers, whatever they are—and brief them on it and then pose a bunch of hypothetical questions and test them and see whether or not it is possible for them to understand it.

I don't share your feeling that the present situation is clear and I would direct your attention to the testimony before this committee which on at least one recent occasion three of the most important people in this industry testified at odds on this question, as to whether or not certain particular actions were in violation of the existing insider trading statutes. And two of the three took one position and one of the three took another. Two of the three thought clarification was necessary. One did not.

My point is, if the leaders of the industry who have come to testify before a committee of the Senate are uncertain about it, what about some poor devil who is just a stockbroker, one of the 6,000 at Merrill Lynch or whatever it is, who's just trying to do his job, or what about somebody just a businessman and isn't even in the industry but may want to do it?

So I would encourage, as you develop this proposal, to maybe market test it inside the agency in some way to see whether or not the proposal you send up really can be understood even with effort. I can understand that somebody might have to invest some hours, maybe even some days, studying these areas of the law.

If I have a little time left and I see the light is still green, I have one other—in fact, I've got several other matters I'd like to talk about, but one I'd like to raise at this point.

Can you violate the insider trading law by not trading? In other words, clearly if you have inside information and trade on the basis of it that's a violation. Suppose you are intending to trade and then come into possession of such information and then don't trade. Does that violate the law?

Mr. Cox. I've seen that very interesting argument and it's always a little dangerous for SEC commissioners to make a statement on the basis of a hypothetical situation because, lo and behold, the first thing you know there's a fact pattern where some of that is involved.

But the kind of situation you outlined, where someone doesn't trade, I think generally I would say no.

Senator Armstrong. Thank you, Mr. Cox.

Thank you, Mr. Chairman.

Senator Riegle. Senator Wirth.

Senator Wirth. Thank you very much, Mr. Chairman.

Commissioner Cox, we are pleased to have you here and once again I greatly appreciate your help and testimony.

You and the SEC were getting beaten up pretty badly a few minutes ago and I would like for the record, if I might, just to put some of this history as I remember it in any case in a little bit of perspective. This reflects my own belief that in this whole issue we ought to be going slowly and very, very carefully and not rush in. Even if rushing in might sound very good for a moment, I think long term we should be very careful.

The argument was made a little earlier that the Supreme Court had said a more specific definition was absolutely needed and I think, for the record, it might be appropriate to point out that what the Supreme Court has said is quite ambiguous on that subject as well. And I quoted an earlier statement by the Court earlier this week that the Supreme Court had said that the securities laws should not be construed technically and restrictively but should be used flexibly to effectuate their remedial purposes. I think that's very contrary to what was said earlier. I want to say that for the record.

Also, in response to why no definition of insider trading had been written earlier, it was my recollection of that, that that was not because the SEC had lagged behind writing a definition but rather for two other reasons. One, there was no agreement in the Congress that we ought to write a definition of insider trading, or that one could be written that was effective; and two, as I remember it at the time that legislation was written, the *Dirks* case had just come down and what we had agreed we would do is to wait and see what the impact of the *Dirks* case was and wait and see how that would be carried out in the lower courts.

Is that your recollection of what transpired at that time, too?

Mr. Cox. Basically, I believe that that's correct.

Senator Wirth. Well, if that's the case, then it seems to me the next question ought to be whether the statements made by the SEC in its annual reports to the Congress which have suggested, as I remember, that the *Dirks* decision has not adversely affected the SEC's enforcement activities—is that still the case?

Mr. Cox. That is correct. As I recall two cases that were lost, it was on the basis of the facts. The Court simply didn't believe the facts as alleged by the SEC. It was not because of the *Dirks* decision.

Senator Wirth. So to suggest that the *Dirks* decision had had an adverse effect on the SEC's ability to carry out its enforcement mandate is not the case, is that correct?

Mr. Cox. I am convinced we have had a successful enforcement program.

Senator Wirth. I just wanted to make that point for the record.

Let me go on to another point that was made earlier this week. One of the justifications for rewriting this legislation or expanding the definition of insider trading was to articulate Congress' point of view, the argument being made that Congress has not made itself clear as to whether the Congress was for or against insider trading I gather.

It seems to me that the findings and all of the history in the legislative record in the Insider Trading Sanctions Act of the mid-1980's is absolutely clear as to what Congress thinks about insider trading.

Do you have any ambiguity about what the Members of Congress believe about insider trading?

Mr. Cox. Certainly not, Senator.

Senator WIRTH. I didn't think so.

Mr. Cox. I thought that the Insider Trading Sanctions Act was a clear directive that there should be additional penalties for insider trading, that Congress wanted the activity deterred.

Senator WIRTH. So, therefore, to suggest as one justification, as was made by a couple of our witnesses earlier this week, that we needed a greater sense of Congress' perspective on insider trading—and that came as a surprise to me and I gather that it does to you as well?

Mr. Cox. Well, I don't believe that it's necessary to have Congress say that Congress is against insider trading and wants to deter it, but as I mentioned a few minutes ago, I think that it might be useful if Congress took some steps to really set the parameters on what's in and what's out.

Senator WIRTH. And that's what you all are trying to do?

Mr. Cox. Correct.

Senator WIRTH. If we want to write a bill saying further about our position on insider trading, that's fine with me, if that's not adequately done. I would just be surprised if that were not adequately in the law.

Let me ask you, does the SEC feel that it has sufficient rulemaking authority under present law to deal with insider trading?

Mr. Cox. Yes, Senator, we do.

Senator WIRTH. OK. Just as a final point, as you are working on this, would it be possible—I have a lot of things in the bill that I think make sense—the draft legislation that we're working on and some other questions about it—would it be possible to send to you a letter summarizing some of the perspectives that I might have on this and maybe you could include that in your deliberations leading up to your August 3 agenda?

Mr. Cox. I would be glad to have such a letter.

Senator WIRTH. I will see if I can put that together and send it off to you.

Thank you very much, Mr. Chairman.

Senator RIEGLE. Let me just ask, Commissioner Cox, should we infer from that last colloquy that there is not a problem with court interpretations? Some of the questions go precisely to that point, but if you go from the declaration of congressional intent in the past to the ultimate application of the law in terms of court test in specific cases, am I to conclude from what you're saying that you're satisfied that the courts are finding the law clearcut enough to be able to sustain you on the cases that you bring and that there's no uneasiness in that area?

Mr. Cox. As we're both aware, the current case that will be considered by the Supreme Court, *United States* v. *Carpenter*, that involves Mr. Winans' activities, poses a real question of what the Court will say about that.

Senator RIEGLE. Why does that pose a real question?

Mr. COX. Well, an adverse decision to the Government in that case could have serious implications for the misappropriation theory, on which a number of the SEC cases are brought.

Now, again, the Supreme Court's decision could be very broad with respect to misappropriation or very narrow, and I have no way of forecasting which.

Senator RIEGLE. But none of us do, although there seem to be some straws in the wind and there is some body of thought that maybe the case will go the other way and that the Court will not find guilt here.

And should that happen—I mean you've just said that that, in a sense, would be a setback—at least that's what I infer from your comment—and it seems to me if that happens or if we're running the risk of that happening, that that sort of continues the line of discussion that says that clarity of the law at least in that area may have some real value.

Mr. COX. Oh, certainly. I think that an adverse decision that threw out the misappropriation theory would make a statute absolutely necessary for the kinds of cases that the SEC has been bringing.

Senator RIEGLE. That's my point. And your colloquy with Senator Wirth, the discussion was on whether or not there's been a clear signal of congressional intent, and it seems to me that congressional intent stated in the past isn't the same thing as carefully written law and that you can find yourself in a situation where the Congress may have said what it would like to see, but if it doesn't in fact nail it down with very carefully written law you may have a gap, and the *Winans* case may fall into that gap. Isn't that a possibility here?

Mr. COX. It's certainly a possibility.

Senator RIEGLE. If that were to happen, though, would that be a description that would fit the case there that in fact a more tightly written law might have allowed us to sustain that case if it otherwise is not sustained?

Mr. COX. I suspect that that's possible. I take it you're asking me—if there had been a statute that clearly included Mr. Winans' conduct, then would that have removed some of the uncertainty about whether his conduct violated the law? Yes.

Senator RIEGLE. Well, yes, but we're fencing a little bit with one another. The point I'm making is that the Congress declares congressional intent all the time. We pass congressional intent items in an endless variety of forms. We have sense of the Senate resolutions. We do this, that, and the other.

The point remains that unless we are willing to take the time to be very careful legal craftsmen, especially in this area of the law, and lay it out, we can find that very diligent prosecutorial efforts can go forward, you can bring cases and lose them, even though one may argue that they should not be lost, simply because we haven't done our job properly of laying the legal foundation in such a way that the courts would say it's clearcut, that we've left too much ambiguity.

I realize you're sort of walking the line here and we all are in terms of the use of the illustrations and just the words that we're selecting to use to make them, but the fact of the matter is, is that we need more precision in the law. You are in effect saying that. And that ought not to be confused with some sort of a signal of congressional intent, if it doesn't complete the job in carefully written law.

Mr. Cox. I advocate precision in the law, yes, sir.

Senator Riegle. Senator Bond.

Senator Bond. Thank you very much, Mr. Chairman.

Commissioner Cox, I'd like to thank you for the work and the effort and the enlightenment you have given us today. We appreciate your testimony. I would associate myself with the remarks made by both of my distinguished colleagues from Colorado. I was particularly grateful to Senator Armstrong who used the term "good lawyer" without implying that it was an oxymoron.

WALL STREET JOURNAL'S DEFINITION

I'd like to ask you about another test that's been recommended. Another critic of the measure before us today is the Wall Street Journal and yesterday in an editorial they criticized this approach and they came up with their own approach, which was essentially that insider trading is the use of stolen information. What do you think of that definition?

Mr. Cox. Certainly a simple definition, but I believe that it is too simple. Certainly it sounds good to ask whether the information was stolen—but we have a number of cases where the information has not been stolen technically. You couldn't bring the case and say that it was the same as a burglar going into offices and finding information and taking it out. For example, people come into possession of information in a legal way—through some relationship of trust and confidence they are entitled to the information—but then convert it to their own use for personal gain. That's the kind of thing we were looking at in the case of Dennis Levine, for example.

But I understand the appeal to saying the test should be whether someone has stolen information.

Senator Bond. You don't think if they use it in violation of trust or as in the *Winans* case, if they used it in violation of a set policy that would constitute stolen information? You think that definition would be nil?

Mr. Cox. Well, I think there is a question under the law of just how that would be interpreted. I would suggest the Wall Street Journal has taken a substantial interest in this subject. I would invite them to submit a statutory definition.

Senator Bond. That will be interesting. We'll await that.

I take it that you probably don't agree with Dean Manne of George Mason who told the committee earlier this week that insider trading is harmless or even beneficial? You would disagree with that?

Mr. Cox. Yes, Senator, I do.

Senator Bond. Why?

Mr. Cox. I believe that in a number of cases harm results from the use of information that is not intended for use by an individual—it may harm the corporation, its plans, its business, or the shareholders of that corporation. So I don't believe that there is no one harmed.

Senator **Bond**. Going back to the specific proposed definition which is before us today, can you think of any cases that under current law would constitute insider trading, but that might be missed by this definition that is before us, or do you have perhaps a hypothetical that you think would escape under this definition?

Mr. **Cox**. The basic prohibition section of the Pitt proposal is quite broad and any of our cases would come within it. So it would exclude none of our cases.

Senator **Bond**. What about the problems you see with the statute's application to firms? Apparently, you feel it would broaden the exemption. Do you feel it would allow a firm to escape liability if they merely showed that they had adequate procedures for the Chinese wall? Would it do away with the current law that the firm has to show that the person actually doing the trading did not have knowledge of inside information?

Mr. **Cox**. Well, there is an ambiguity there and it seems to change the defense as it stands under current law. We point out in our testimony that it's unclear just what role would be played by the procedures which the Pitt definition suggests would be evidence.

Currently, the law requires procedures in addition to lack of knowledge by the individual making the trading decisions. It's unclear just what sort of change this proposal makes and what the implications of that change would be.

Senator **Bond**. Thank you, Mr. Cox.

Thank you, Mr. Chairman.

Senator **Riegle**. Senator Karnes.

Senator **Karnes**. Mr. Chairman, thank you. I yield my time to my colleague from Colorado.

Senator **Armstrong**. Does Senator Proxmire have more questions?

Senator **Proxmire**. I just have a couple more questions of Mr. Cox.

Mr. Cox, isn't the harm of insider trading to outsiders very evident? You have a market here in which in most cases you have probably very few insiders, people who are corporate directors, people who may have the capital and decide to move in on a corporation and their friends. On the other hand, you have the great majority of investors, big and small, who are outsiders who don't know.

IS THE MARKET RIGGED?

Doesn't that mean that the market is rigged? Doesn't that mean that the people who know that the stock is going up or down have inside, nonpublic information, and haven't stolen it? The Wall Street Journal says you have to steal it. Let's say you're a corporate director. You decide that for the first time in 50 years your corporation is going to skip a dividend. It's a big event. You know it and you know that because of it the stock is going down. So you sell the stock short or your friends sell it short or your wife sells it short.

It seems to me that that is wrong, vicious, and undermines the integrity of the markets, and I think we should act on it.

And with what we have in the Pitt definition we would be able to do that, isn't that correct?

Mr. Cox. Oh, yes.

Senator Proxmire. On nonpublic information?

Mr. Cox. Certainly. The Pitt definition, as I said, is very broad and certainly covers the example that you just gave, Senator, which is basically the traditional insider trader, an officer or director of a company. I think that you are correct, that the decision that's been made is that the harm in this is transferring wealth from outsiders to insiders. I think that that's the point.

Senator Proxmire. Why shouldn't there be a presumption that if you trade while possessing nonpublic information, you have traded on the basis of that information? It seems to me the only way you're really going to get at insider trading because there undoubtedly is an enormous temptation here. Probably a great deal of insider trading is going to go on unless you have severe laws and vigorous prosecution. If you say the presumption has to be on the prosecutor to prove that a person who had that inside information traded in the stock because of it, it seems to me that you're going to pretty much paralyze effective enforcement.

Mr. Cox. From an enforcement perspective, the presumption that someone who was in possession traded on the basis of this information is very important. The current law is that the violation is trading while in possession of the information.

It may be difficult to go the next step and prove that it was on the basis of that information, as I stated before. We've come across a lot of post hoc explanations for trading, which often don't hold up but create a tremendous burden to overcome when we try to prove our case.

Senator Proxmire. Thank you, Mr. Chairman.

Senator Riegle. Senator Armstrong has a couple of matters he wishes to raise and then I'll raise a couple.

Senator Armstrong. Mr. Chairman, thank you.

Commissioner Cox, I'd like to take a few minutes at least to be sure that we're on good ground about why we're doing this. It's sort of the same general range of issues that Senator Proxmire was getting at.

What we're seeking to do is to establish whatever ground rules are necessary to make this thing fair, that instinctively, whether there's any damage done or not—I think it's pretty hard to show whether or not there's damage as a result of insider trading and it would be hard to prove, but even if there isn't, even if nobody is injured, somehow it offends our sense of justice, I guess, if somebody who is an insider benefits from that position of trust. I guess you would agree with that. I don't think that's controversial. In other words, if they know something is going to happen tomorrow and they trade today as a result of it.

Mr. Cox. Well, beyond that, a manager or director of a corporation has a fiduciary duty to the shareholders of that corporation. So it's not just unfairness, but violation of a duty.

Senator **Armstrong**. Well, assuming that there is a loss to them, it's conceivable that somebody might argue—in fact, I gather it was argued—that no loss to the shareholders would result. But I'm just saying, beyond that issue, that it offends our sense of justice somehow that somebody who is a director and who knows that tomorrow's announcement of quarterly earnings or something is going to be up or down or whatever and then trades on that information, it just kind of rubs us the wrong way. I'm not trying to trap you or anything. I just take it for granted we would all agree with that.

Mr. Cox. Yes.

Senator **Armstrong**. But I think the unspoken assumption is that if we put the right kind of laws and regulations in place we're going to create a level playing field, that everybody will be bound by the same rules and, therefore, the average guy on the street will have the same chance to profit from the news of the quarterly earnings report that the director has. Is that kind of a general statement of objectives?

Mr. Cox. Well, I think that there seems to be a wide range of opinions about this. At one extreme, you have some arguments that there is no harm to insider trading so nothing should be done about it. At the other extreme, there is an argument that everyone should have equal information, the level playing field that you referred to. I think that that's impossible. There are some other people who make their living studying annual reports, doing analysis of securities and so forth, while some people simply trade on the basis of what their broker suggests. So there won't be equal information.

In the middle someplace I think is more what people are getting at in proposing laws to regulate insider trading. There is a belief about equal access to information—that if someone wants to take the time to study reports and wants to make that investment, that person should be able to, but there shouldn't be some special access to inside information of the kind that you talked about.

Senator **Armstrong**. Well, you're getting very quickly to the point that I'm concerned about—or one of the points that I'm concerned about.

No matter how carefully we draw insider trading regulations and no matter how scrupulously and ethically they are enforced, the reality is this. And no matter how astute I may be as a reader of published financial statements, if I'm thinking about the Widget Institute, I will never have an equal opportunity with somebody who has spent a lifetime in the manufacture and distribution and sale and management of widget operations. I mean, that's just a fact.

And the truth of the matter is, that the real inside information, which is never addressed in this legislation and really can't be and shouldn't be, is just the know-how that derives from being involved in the operations. Somehow, the idea that we're correcting a serious and widespread abuse that really affects in a practical way the investment outcome of a lot of shareholders I think is greatly exaggerated. That doesn't mean it's right for people to steal information or to trade on insider information, but I think we ought to be cautious about how much we think we're really getting done.

OFFICERS OWN LITTLE STOCK IN THEIR COMPANIES

I also have a kind of a concern that is related to this that I would at least like to raise and ask you to comment on or think about or do something. I note that in the effort to make the system a little more fairer over the years, what we have really done is discourage almost exclusively the ownership of stock in public corporations by the people who manage them. We have a situation in virtually all of the big companies of this country where the guys who are the directors and officers of this company don't own any. They own one share or a thousand shares. Typically, if you look through all the published reports, they own much less than 1 percent of the outstanding shares, all of the directors and officers put together. Sometimes, a 1/10 of 1 percent.

Why is that? Well, the reason, I'm told, is because the disadvantages, the obligations, the penalties for dealing in the stock of the company you own are so great that it's just not prudent to do it. You work for General Electric but you trade in the stock of General Motors or something else.

Now that resolves the fairness issue, but what it also does is create a system in which the people who manage these enterprises have basically no economic stake in the ownership performance. In my opinion, that may turn out to be a much worse practical problem than any insider trading we've seen. What do you think?

Mr. Cox. Well, there certainly are reporting requirements for corporate officers and directors involving their stock dealings. I think a number of corporations have programs where it's only at the time of an annual or quarterly report that the traditional insiders sell or buy so that they won't be selling or buying while in possession of material, nonpublic information.

But also, I'm a little puzzled because in another important issue that the SEC and Congress are considering these days, the area of takeovers, so often we hear the argument that management of companies is concerned for the long term while takeovers are forcing attention to the short term. I would think that people really concerned with the long term outlook of a company wouldn't be so dissuaded by the inability to trade short term—that they would be willing to buy and hold the stock. So I am puzzled a little bit by the inconsistency of those arguments. But I'm getting a bit off the track from what you just asked.

Senator Armstrong. Mr. Chairman, my time has expired and I don't know what the schedule of the committee is. Can I proceed for a few minutes or do we need to move on to other things?

Senator Riegle. Well, let's do this. I need to step out for a moment and I'll be right back, so I think if you'd like to pursue it you should do so and then I'll come back.

I want to say one thing at this point. I don't want to interrupt the line of your discussion, but I very much appreciate the testimony you've given today. I think it's been very helpful to us and I think it lays the foundation of a process that we can follow here where we work to find the adjustments and the refinements that are needed to give us what I think most of us really want, and that is a definition that really fits the problem and is given the care on the front end so that when we end up with it it will be something that will really serve the public interest.

But let me turn the gavel over to my colleague here and I will return very shortly.

Senator ARMSTRONG. This is the moment I've been waiting for. Thank you, Mr. Chairman.

Senator RIEGLE. You have my full faith and confidence.

Senator ARMSTRONG. The point I'm getting at—and may I ask you to just think about it as an economist or as a shareholder—is it desirable to have in broad public policy terms a greater degree of integration between management and ownership of these large public corporations? Do you have any opinion about that?

Mr. COX. I certainly think that that kind of integration, holding stock in the company, gives a strong incentive to the management to operate that company in the best interest of the shareholders, which I believe is the purpose for management in publicly held companies.

So I basically think that ownership of the company shares by management is a good thing.

Senator ARMSTRONG. That's my feeling in general, not to say that all companies where that's not true are poorly managed and certainly not to say that all companies where the managers and officers and directors own big blocks of stock are well-managed because obviously there are examples to the contrary, but just as a general public policy, it does appear that when the people who run the business have an ownership interest of consequence in it, when they've got a big block of stock or a big part of their net worth is tied up in the ownership of stock, then that is a reassurance to the shareholders and, in general, that's good public policy I think.

Now through whatever reasons, insider trading rules or whatever, that has been heavily discouraged and I think it's a cause and effect relationship. You're perhaps better able to comment on it than I am, but I know lots of businessmen. I know lots of businessmen who are asked to serve on the boards of directors of companies. I know some who like to do it and do it regularly. I know lots of others who would be terrific directors who I'd like to have on the board of any company I owned stock in who just say, "You've got to be crazy. I wouldn't dream of getting on a board of a public company. The risk isn't worth it. The danger isn't worth it." And I'm not talking about just big companies. I'm talking about the neighborhood bank. Banks all over this country are having trouble getting good people to serve on their boards of directors because, in that case not securities law but other considerations. But I do note a huge percentage—I haven't tried to quantify it, but a huge percentage of the major companies in this country simply are managed by people who are not to any real extent owners.

Am I correct in assuming this is a result of the legal responsibilities that they come under and that they are discouraged from doing so either by statutes or regulations?

Mr. COX. I guess I would hesitate to reply that that is the explanation. I don't know the precise explanation, but I know what I hear and we talk to a lot of business people and representatives of business people through our work at the Commission, and one thing that I hear time and again is about the potential liabilities of officers and directors.

I would certainly not say that those problems exist because of insider trading laws. I think that there's a whole range of——

Senator **Armstrong**. You mean not solely because of insider trading laws?

Mr. Cox. When I say liabilities, I'm talking about the possibility of being sued for any of a number of reasons and the problems that we've heard lately, about obtaining insurance for directors and that kind of thing. Those are the kinds of complaints that I've heard business people make about the hesitancy of people to serve on boards.

Senator **Armstrong**. Well, you apparently have been talking to some of the same people I have or at least they are saying some of the same things, and it does appear to me that, to the extent that we apply draconian sanctions on insider trading or to the extent that we tighten the statute down, and particularly, most important, to the extent that it's ambiguous, that we really just discourage people completely from owning stock.

If I'm a businessman and I'm a director or vice president or president of a public corporation and there's any real doubt about what the insider trading rule is, the prudent thing to do would be to find some way to get my shares in the company I work for or of which I'm a director or officer reinvested into something that I don't have any inside connection with, because if there's an ambiguity, if there's a question of where the line is, then the only prudent thing to do is just to avoid that kind of exposure. At least that's the way it seems to me.

And I don't know what to do about that. That's not to say, therefore, we should have a very narrow insider trading provision. It is to say I think we need to have great clarity.

In closing, I want to return to where I started. My interest is not so much simplicity. The people that we are talking about here are smart, able, sophisticated people. In many cases, they are well advised by legal counsel, though not in every case, and it's reasonable for them to invest some time and effort in understanding the business that they are engaged in. But having said that, I'll have to tell you, as a businessman and as a member of this committee for 8 or 9 years, it's hard for me to understand at the margins what insider trading is.

Now it's clear to me that there's a lot of things, probably 95 or 98 percent of the kinds of cases we've discussed, that we could all even by secret ballot just agree which side of the line those are on. But at the margins, in things like the *Winans* case, it isn't clear.

I guess I just want to communicate that it scares a lot of business people to death and I think justifiably so.

David, have you got anything more?

Senator **Karnes**. Just one question.

Mr. Cox, Senator Armstrong has raised a number of interesting issues on this entire topic. I would like to hear your response to the characterizations that the Senator has made concerning if indeed this is a problem in your mind that would affect the interest or willingness of talented individuals to serve on boards and that the insider trading restrictions, having just 12 weeks ago being involved in the corporate environment dealing with directors and officers insurance liability problems and looking at the skyrocketing premiums and those concerns—we weren't as concerned—of course, this was a privately held company in part, although we had publicly owned subsidiaries—with the insider trading restrictions. But nonetheless, I believe Senator Armstrong with the people that he has been talking with have indicated that this is indeed a problem with directors and that the insider trading laws as they now exist with their perceived confusion and with what's happened lately has created a chilling effect on those individuals who probably we need most to become directors and officers.

My question I guess to you is maybe a yes or no question. Do you believe and have you found in your experience that this has had a chilling effect on the willingness of people to serve—insider trading restrictions I mean and lack of clarity in those laws?

Mr. Cox. No. I have not found that through my experience. I've heard people talk about insider trading and when I'm at conferences and so forth a number of business people will ask me about it. I have no study, no empirical evidence, that kind of thing—but I have not found that insider trading laws are having that chilling effect.

I believe that most corporations provide quite a bit of help for managers and directors through the corporate counsel and so on to make sure that they don't run afoul of the restrictions. But all I'm doing is just giving anecdotes.

Senator Karnes. Well, I appreciate that. I believe that that is a consideration, but there probably are other things that are more predominant in the minds of officers and directors, particularly in the liability insurance area, and that is indeed an emerging consideration I'm sure of those members of the board of directors of larger publicly held companies. I thank you for that response.

Thank you, Mr. Chairman.

Senator Riegle. Thank you, Commissioner Cox, and let me just say again that I appreciate your testimony today and I appreciate the work where the commitment has been made to come back with a recommendation and I appreciate your service on the Commission. This is a difficult time and it's a tough job and we need good people in tough jobs. So I just thank you for that service to the country as well.

Mr. Cox. Thank you very much, Senator.

Senator Riegle. We're pleased to have you.

Dr. Moore, let us have you come forward now, if you will.

Dr. Moore, let us welcome you to the committee. It's widely reported in the press that shortly after the Boesky scandal broke that the administration and the domestic policy council would set up a working group under George Gould at the Treasury to see what ought to be done about insider trading and corporate takeover abuses. We invited Mr. Gould here today to testify and, as you know, he declined, so you're the administration spokesman on the issue and two things that I'd be interested in knowing just as you lead into your testimony, I'd like you to give us a reading as to the status of this working group that was set up in the administration to look into these subjects, where is it, are you on it, have any conclusions been reached; and also, I'd like to have you just for the record as well give us something of your background in terms of this area that we've talked about today just so that we have that in the record here.

STATEMENT OF THOMAS G. MOORE, MEMBER, COUNCIL OF ECONOMIC ADVISERS; ACCOMPANIED BY SUSAN WOODWARD

Mr. **Moore**. Thank you, Senator Riegle. I am very pleased to be here today to testify on insider trading. I brought with me Susan Woodward from the staff of CEA.

In terms of your two questions, let me first address those. My colleague, Michael Musa, who is on vacation, is on the working group, the one that you referred to, chaired by George Gould, on these issues.

They have been studying this issue but have so far come to no conclusions that I can report today.

Senator **Riegle**. No conclusion that you can report today?

Mr. **Moore**. That's right.

In terms of my own background, I'm an economist whose specialty is industrial organization and government regulation of business. I have done a little work in the securities area but not anything specifically on insider trading, so I do not hold myself out as an expert on that area.

Senator **Riegle**. I understand. Can I ask then, I understand that Mr. Musa, who is on this working group, is on vacation. And he, otherwise, would normally be here and you've been asked to fill in for him. I don't want to just be very hardnosed on you because you've been given the assignment and you're here and you're frank to say you're not an expert in this area, but I must say that we've got a pretty good sized Treasury Department and we spend a lot of money each year to hire a lot of good people there and there are a lot of people there who are quite knowledgeable and expert in this area, and I'm just wondering why none of them are present. Do you have any sense for why that's so?

Mr. **Moore**. I wouldn't presume to comment on why they are not here.

Senator **Riegle**. Well, let me just say for the record that I'm very disappointed in that. That isn't to in a sense not welcome you to the committee because you have been asked to carry the mail and you're here to do it and I appreciate the fact that you are, but there's really no excuse for the administration not responding on the seriousness of this matter by sending up a person who is deeply involved in this area and the notion that one person is away on vacation is hardly a sufficient excuse on behalf of the administration.

So we're going to need to have something more forthcoming than that from the administration and we will pursue that in other ways.

But let us hear what the administration wants to say to us today.

Mr. **Moore**. Thank you, Senator.

This issue is both important and timely and I share your concern on the topic. I regard free and efficient securities markets as one of the most valuable assets to our country. To establish public policies to encourage broad participation in these markets is critically important to the Nation's capital formation, job creation, and investment in new plants and equipment.

Clear rules on trading activity are important to well functioning markets, including securities markets.

I have not had an opportunity to review the proposed legislation in detail but I can offer the following preliminary observations.

PRELIMINARY OBSERVATIONS

No one condones illegal insider trading activity and the recent prosecutions show the vigilance of the Securities and Exchange Commission in combating the fraudulent use of proprietary information relating to publicly traded corporations. But the absence of a legislative definition of insider trading is a primary source of confusion. Section 10 of the Securities and Exchange Commission Act of 1934 proscribes fraud "in connection with" the sale of any security. But the securities laws do not define what constitutes insider trading. Instead, they rely on the courts to develop a common law definition. The Supreme Court has addressed the issue twice in recent years. Later this year, the Court will have the opportunity to revisit the question in the *Winans* case. As you are aware, the Department of Justice is defending criminal convictions against a Wall Street Journal reporter and his confederates for trading on confidential information taken from his employer.

We believe it would be better to wait until the Supreme Court has reviewed the *Winans* case before any legislation is considered. After the Court decides this case, we can better consider how the law might be changed. Until that time, legislation is premature.

Insider trading is a difficult issue, if for no other reason than it is difficult to detect when it is occurring. One of the allegations made by those very concerned with insider trading is that it undermines the confidence of the public in the integrity of the stock market. Without minimizing the problem, we observe, however, that the market is booming and that the volume of trading continues at all time highs.

Moreover, the system is working. Criminals are being prosecuted and the ones who are being prosecuted in the *Boesky* and related cases are not involved in borderline cases, nor in cases where the definition of insider trading is in dispute.

Thus, I believe that Congress can and should wait until after the Supreme Court makes its decision in the *Winans* case before seeking to markup legislation in this area. However, in the long run, it may be desirable for Congress to carefully define insider trading.

Ultimately, a legislative definition of insider trading would help promote the efficient use of information by making it crystal clear what is and is not legal. Though I would not want to speculate on what an appropriate definition would be, I would like to outline concerns we think will eventually have to be tackled if a definition is to be arrived at.

Some have argued that insider trading occurs whenever there is a trade in which one party is better informed than the other. But this would be an overinclusive definition, for it would encompass any trade—and not just in securities—where the buyer and seller have disparate information. Information disparities can arise from a variety of circumstances. From the point of view of market regulation, it is not disparities of information that are relevant. A definition based on a lack of parity in information would inhibit the normal functioning of markets and I oppose such a definition.

Consider, for example, a trader with superior information who acquires that information by independently devoting time and energy investigating the commercial prospects for a particular public corporation, its product, and its market. He can then exploit the information disparity, but it is one created by his own valuable investigation.

This case is very different from the one in which a director of a corporation trades on nonpublic information regarding the corporation's future income stream, information acquired in his fiduciary role with the corporation. This trader's superior information does not result from independent investigations or acumen, but from outright theft of an asset belonging to the shareholders of the corporation. For this trader to buy stock, based on inside information before the information is made public and reflected in a higher stock price, is equivalent to his stealing from the corporation.

Such theft, based on breach of fiduciary or other legal duty, is what I believe should be regarded as insider trading. An objective definition is preferable so that market participants can understand their rights and obligations. Moreover, since violations are subject to SEC enforcement suits, private litigation, and criminal penalties, and since the penalties are high, Congress needs to keep the litigation context in perspective. A subjective or imprecise standard may, in practice, lead to traders not acting on legitimate information differences because of their concerns with possible litigation costs.

We regard nonpublic information possessed by a corporation as private property. That much of this information has proprietary value is beyond dispute. The improper use of this information is a theft of private property.

The SEC embraced this theory of insider trading in a series of cases against corporate officers and directors who traded in the stock of their own company without honoring their fiduciary duty to the corporation and its stockholders. This type of action is as much stealing as the padding of expense accounts. In the landmark *Texas Gulf Sulphur* case, the court accepted the SEC's reasoning that corporate officers or directors breached a fiduciary duty to investors if they bought stock without disclosing material information, and that this breach constituted a deception punishable under securities laws. These are situations in which information was misused. The managers were supposed to be acting in the shareholders' interest, not misappropriating information from them. Instead, they acted like an employee who charged a personal vacation to a company expense account.

The purpose of the market is to provide businesses with access to capital for investment and the creation of jobs. This function is best fulfilled when the market attracts a broad range of participants who have confidence in its operation and understand clearly its rules. A legislative definition of insider trading would clarify the responsibilities of those who trade in the market, enhancing investor confidence, minimizing the threat of litigation arising from ambiguous provisions, and thus lowering the cost of capital.

Thank you.

[The complete prepared statement of Thomas G. Moore follows:]

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON D C [illegible]

FOR RELEASE UPON DELIVERY
EXPECTED AT 10 A.M. EST

STATEMENT BY THOMAS G. MOORE
MEMBER OF THE COUNCIL OF ECONOMIC ADVISERS
BEFORE THE
SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
WASHINGTON, D.C.

FRIDAY, JUNE 19, 1987

I am very pleased to be here today to testify on insider trading. This issue is both important and timely, and I share your concern on the topic. I regard free and efficient securities markets as one of the most valuable assets of our country. To establish public policies that encourage broad participation in these markets is critically important to the nation's capital formation, job creation, and investment in new plant and equipment. Clear rules on trading activity are important to well-functioning markets, including securities markets.

I have not had an opportunity to review the proposed legislation in detail, but I can offer the following preliminary observations.

No one condones illegal insider trading activity, and the recent prosecutions show the vigilance of the Securities and Exchange Commission in combating the fraudulent use of proprietary information relating to publicly traded corporations. But the absence of a legislative definition of insider trading is a primary source of confusion. Section 10 of the Securities and Exchange Commission Act of 1934 proscribes fraud "in connection with" the sale of any security. But the securities laws do not define what constitutes insider trading. Instead they rely on the courts to develop a common law definition. The Supreme Court has addressed the issue twice in recent years. Later this year, the Court will have the opportunity to revisit the question in the Minans case. As you are aware, the Department of Justice is defending criminal convictions against a Wall Street Journal reporter and his confederates for trading on confidential information taken from his employer.

We believe it would be better to wait until the Supreme Court has reviewed the Minans case before any legislation is considered. After the court decides this case we can better consider how the law might be changed. Until that time, legislation is premature.

Insider trading is a difficult issue, if for no other reason than it is difficult to detect when it has occurred. One of the allegations made by those very concerned about insider trading is that it undermines the confidence of the public in the integrity of the stock market. Without minimizing the problem, we observe, however, that the market is booming, and that the volume of trading continues at all time highs. There is little evidence of harm to stockholders. Moreover the system is working. Criminals are being prosecuted, and the ones who are being prosecuted in the Boesky and related cases are not involved in borderline cases, nor in cases where the definition of insider trading is in dispute.

Thus, I believe that Congress can and should wait until after the Supreme Court makes its decision in Minans before seeking to mark-up legislation in this area. However, in the long run, it may be desirable for Congress to carefully define insider trading.

Ultimately, a legislative definition of insider trading would help promote the efficient use of information by making it crystal clear what is and is not legal. Though I would not want to speculate on what an appropriate definition would be, I would like to outline concerns we think will eventually have to be tackled if a definition is to be arrived at.

Some have argued that insider trading occurs whenever there is a trade in which one party is better informed than the other. But this would be an overinclusive definition, for it would encompass any trade (and not just in securities) where the buyer and seller have disparate information. Information disparities can arise from a variety of circumstances. From the point of view of market regulation, it is not disparities of information that are relevant. A definition based on lack of parity in information would inhibit the normal functioning of markets, and I oppose such a definition.

Consider, for example, a trader with superior information who acquires that information by independently devoting time and energy investigating the commercial prospects for a particular public corporation, its product, and its market. He can then exploit the information disparity, but it is one created by his own valuable investigation.

This case is very different from one in which a director of a corporation trades on nonpublic information regarding the corporation's future income stream, information acquired in his fiduciary role with the corporation. This trader's superior information does not result from independent investigation or acumen, but from outright theft of an asset belonging to the shareholders of the corporation. For this trader to buy stock, based on the inside information, before the information is made public and reflected in a higher stock price, is equivalent to his stealing from the corporation.

Such theft, based on breach of a fiduciary or other legal duty, is what I believe should be regarded as insider trading. An objective definition is preferable, so that market participants can understand their rights and obligations. Moreover, since violations are subject to SEC enforcement suits, private litigation, and criminal penalties, and since the penalties are high, Congress needs to keep the litigation context in perspective. A subjective or imprecise standard may, in practice, lead to traders not acting on legitimate information differences because of their concern with possible litigation costs.

We regard nonpublic information possessed by a corporation as private property. That much of this information has proprietary value is beyond dispute. The improper use of this information is a theft of private property.

The SEC embraced this theory of insider trading in a series of cases against corporate officers and directors who traded in the stock of their own company without honoring their fiduciary duty to the corporation and its stockholders. This type of action is as much stealing as the padding of expense accounts. In the landmark Texas Gulf Sulphur case, the court accepted the SEC's reasoning that corporate officers or directors breached a fiduciary duty to investors if they bought stock without disclosing material information, and that this breach constituted a deception punishable under securities laws. These are situations in which information was misused. The managers were supposed to be acting in the shareholders interest, not misappropriating information from them. Instead, they acted like employees who charged a personal vacation to a company expense account.

The purpose of the market is to provide businesses with access to capital for investment and the creation of jobs. This function is best fulfilled when the market attracts a broad range of participants who have confidence in its operation and understand clearly its rules. A legislative definition of insider trading would clarify the responsibilities of those who trade in the market -- enhancing investor confidence, minimizing the threat of litigation arising from ambiguous provisions, and thus lowering the cost of capital.

Senator **Riegle**. I like that last sentence. It sounded to me like maybe we've got some basis to try to get something done.

But let me just say, I don't think there is any valid excuse for the administration to be so far behind the curve on this. Everybody is studying it, talking about it. All of the major securities practitioners are active in the debate and feel strongly about it. We've had the recommendation from the U.S. attorney in New York who is bringing most of the major insider trading prosecutions—his strong feeling stated here on the record that there's a need for clarification and a tighter definition of insider trading.

And I think the administration has to get moving. I don't know what's going on as to why this is taking so long because these issues have been around for a long time. And I would just say that I would hope that you take the message back to this working group that maybe they ought to get to work and then take their vacations rather than the other way around because we would like a specific recommendation from you.

As you probably heard, the SEC, as an independent agency, has indicated their willingness to give us their specific recommendations by a date certain.

Are you in a position today to make a commitment from the administration side to come in with a proposal on a time frame like that or by a date certain so that we can have something from you?

Mr. **Moore**. No, I am not, Senator. We believe that it would be premature to move ahead with legislation until we hear from the Supreme Court in the *Winans* case and know what the existing state of the law is before we try to correct it.

Senator **Riegle**. Well, I would just say one other thing about that because this administration has always taken the view that the Supreme Court shouldn't be writing the law, that the laws should be written here in the legislative branch and signed by the President, and that we should not have the courts, in a sense, deciding where the law is going to go.

So to wait for the courts to tell us it seems to me sort of turns the whole Reagan orientation right upside down. It seems to me that everything that I've heard the administration argue is the reverse of that. That is, that we want to have a tightly drawn law, give it to the courts, have the courts stay within the bounds of that law, and not the other way around.

So I think if you dust off some of the President's early speeches in this area, I think you've really got a mandate from the President himself to get ahead of the court, not be behind the court—get ahead of it and decide what you think makes sense and not have this ambiguity out there.

But the notion that we have to wait for a particular court decision to decide what we ought to do in the area of the law here really—I mean, that's just not a strong point to make and I don't think it's in keeping with the basic thrust of everything else the administration has had to say.

What it looks, intentionally or not, is like an evasion. It sounds like the administration, for whatever the reasons, just doesn't want to get into the insider trading problem and they are sort of using that as a dodge. I think that's a mistake. I think investor confidence is at stake. Fairness to shareholders is at stake. And we've got to make sure we've got a workable law.

We had a witness in here yesterday who, like yourself, a doctor, who's conducted some lengthy polling efforts to find out how well existing brokers understand the insider trading law, and he gets very bad results. I mean, people just don't understand it. So if the practitioners in the field don't understand it, it's not surprising that there are going to be abuses taking place. So that's not fair to anybody. That's not fair to the market, not even fair to those individuals. And I assume you've been involved in teaching and I have, too, and it seems to me if we're going to help create a body of instruction to the practitioners who are coming up through the academic ranks and out into the profession that we need to have some clearly drawn legal guidelines here so that we can train people, so we can police the system, so that people that cheat get caught and punished, that we protect the shareholder out there who otherwise may suffer loss in value through absolutely no fault of theirs.

So I would hope you would take the message back that we are looking for something more than that. And I don't just say this to you personally. You have been asked obviously to come in and make the presentation, but in the same respect, as you brought a message, I'd like you to take one back. And the one I'd like you to take back is that we really expect more from the administration in this area. We need some leadership and maybe you can help us get some.

Thank you for coming today.

The subcommittee is in adjournment.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]

[Additional material received for the record follows:]

College of Charleston
Charleston, South Carolina 29424
School of Business & Economics
(803) 792 5627

June 25, 1987

The Honorable Donald W. Riegle, Jr.
Chairman, Subcommittee on Securities
The United States Senate
Washington, D.C. 20510

Dear Senator Riegle:

Thank you for inviting me to testify before the Securities Subcommittee on June 17, 1987, concerning the results of a study evaluating stockbrokers' understanding of the current insider trading rules.

At the conclusion of my testimony you asked me to review the "Insider Trading Proscriptions Act of 1987" and to submit to the Securities Subcommittee any comments I have on the proposed legislation.

The attached document briefly reflects three (3) areas of concern that I have with the proposed legislation.

While I strongly favor a statutory definition of insider trading, I believe these three areas should be reexamined to ensure the law sufficiently covers all prohibited conduct. Reexamining these areas and incorporating these changes will strengthen the proposed legislation by ensuring the broadest coverage.

I believe these changes will result in increased investor confidence in our capital market system.

If appropriate, I ask that my comments be attached to the hearing record.

Thank you again for allowing my testimony and these comments. I would always consider it an honor and a privilege to assist you or the subcommittee in this, or in any other matter.

Sincerely,

Gary Tidwell

Gary L. Tidwell
Associate Professor of
Business Administration

Copies Furnished:

Senator William Proxmire
Senator Alan Cranston
Senator Jim Sasser
Senator Terry Sanford
Senator Richard C. Shelby
Senator William L. Armstrong
Senator Christopher S. Bond
Senator John Chafee
Senator Alfonse D'Amato
Senator Chic Hecht
Mr. Steve B. Harris
Mr. Richard S. Carnell

Three Areas of Concern in the Proposed "Insider Trading Proscriptions Act of 1987"

by
Gary L. Tidwell
Associate Professor of Business Administration
College of Charleston
Charleston, South Carolina

I. Section 2(b)(1) of the Insider Trading Proscriptions Act of 1987 defines information that has been "obtained wrongfully" as follows: "For the purposes of this Section, information shall have been used or obtained wrongfully only if it has been obtained by, or its use would constitute, directly or indirectly, theft, conversion, misappropriation or a breach of any fiduciary, contractual, employment, personal or other relationship of trust and confidence."

DISCUSSION:

This section imposes liability on those who trade on information obtained wrongfully. While this section defines how information may be obtained wrongfully, I would support a more comprehensive and complete definition of what conduct constitutes insider trading.

RECOMMENDATION:

The following definition of insider trading provides a more straightforward definition of the prohibited conduct:

> "The essence of the Rule is that anyone who, trading...in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," i.e., the investing public. Matter of Cady, Roberts, & Co., 43 SEC 907, 912 (1961).[1]

Thus, "insiders, as directors or management officers are, of of course, by this Rule, precluded from so unfairly dealing, but the Rule is also applicable to one possessing the information who may not be strictly termed an "insider" within the meaning of Sec. 16(b) of the Act. Cady, Roberts, supra. Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed." SEC v. Texas Gulf Sulphur, 401 F.2d. 833, 848 (2d Cir. 1968), cert.denied, 394 U.S. 976(1969).

This definition of insider trading is more comprehensive than the proposed legislation and goes further to restore investor confidence in our capital market system.

Adoption of this concern would eliminate the tipper-tippee situation, and would not require consideration of item II below.

II. Section 2(b)(1) and Section 2(c)(1) discuss the scienter element of insider trading. The plaintiff must prove criminal intent in insider trading cases by showing the defendant "knows or is reckless in not knowing" the information had been obtained wrongfully (or in the case of Section 2(c)(1), a showing must be made that the defendant "knows (or is reckless in not knowing) that such information would be used for a purchase or sale of a security....").

DISCUSSION:

Successful prosecution of an insider trading case requires a showing that the defendant acted with scienter. While the courts have never offered a clear definition of scienter, the courts do require some evidence

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[1] This Rule was cited in SEC v. Texas Gulf Sulphur, 401 F.2d. 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

of "a mental state embracing intent to deceive, manipulate or defraud."[2]

In the typical case, there is no question that the insider traded in order to take advantage of material nondisclosed information that was in his possession. The difficulty of applying scienter arises in a tipper-tippee situation when the insider (the tipper) provides insider information to another (the tippee).

The Supreme Court in Dirks[3] stated that liability is appropriate where the tippee either "knows or should have known there has been a breach."

Thus, in evaluating liability of tippees, the Supreme Court has spoken in terms of a negligence standard, and not, as the proposed legislation would require, the higher standard of recklessness.

The proposed legislation would make the successful prosecution of insider trading cases more difficult. Requiring the prosecution to show the defendant tippee either "knows or is reckless in not knowing" such information was obtained wrongfully, is much more difficult than merely showing the defendant tippee either knew or should have known the information received was obtained wrongfully.

RECOMMENDATION:

I recommend that the scienter standard in the proposed legislation be changed from "knows or is reckless in not knowing" to a standard of "knows or should have known."

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2. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193-94 (1976).
3. Dirk v. SEC, 463 U.S. 646, 660 (1983).

It will be much easier for the prosecution to satisfy the scienter standard using a negligence standard than the more difficult and higher standard requiring a showing of recklessness.

III. Section 2(b)(2)(B) and Section 2(d) limits the application of the principle of respondeat superior by providing a safe harbor for employers and controlling persons upon a showing that such persons have not participated in or induced the violation by the employee or controlled person.

DISCUSSION:

The best way to stop insider trading is to ensure that entities entrusted with insider information (public companies, brokerage houses, law firms, etc) are totally and completely commited to the confidentiality of such information. Respondeat superior, the doctrine of requiring the master to answer for the torts of his servants, will require entities to assume liaibility for its employees' torts. Realizing the potential liability to which these entities are exposed under the doctrine of respondeat superior will encourage these entities to "police their own ranks".

Subjecting the entity to potential liability will help ensure the entity establishes a system of checks and balances and internal controls that will help put a stop to insider trading. The entity's own efforts can be the most effective means of eliminating insider trading.

It seems fundamentally unfair to now carve out a statutory exception to respondeat superior in an area where the agency law is well established.

Under traditional respondeat superior liability, a person who puts an agent "in a position which enables the agent, while apparently acting within his authority, to commit a fraud upon third persons is subject to liability to such third persons for the fraud."[4] This rule, which is followed in most jurisdictions,[5] is based on two well established principles: first, that third persons have been led to believe by the principal that the agent is acting in the normal course of business entrusted to him and second, that as between two innocent parties, the one who created the opportunity for the misconduct should be responsible for the loss.[6]

The proposed legislation would severely limit the doctrine of respondeat superior. As stated above, agency law recognizes respondeat superior, and that entities will be held liable for agents' frauds committed against third parties when the agent was acting within his authority.

RECOMMENDATION:

I recommend that the language in Section 2(b)(2)(B) and Section 2(d) which restricts the application of respondeat superior be eliminated.

The application of respondeat superior should be left to the courts, and should not be limited by legislation.

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4. Restatement (Second) of Agency, Sec. 261 (1957). This rule is not altered by the fact that the agent was acting solely for his own purposes. Id. Sec. 262.
5. See Home Life Ins. Co. v. Equitable Equip. Co., 680 F.2d 1056 (5th Cir. 1982); SEC v. First Sec. of Chicago, 463 F.2d 981 (7th Cir. 1972) (brokerage firm context).
6. See Comment a to Restatement (Second) of Agency Sec. 261; Hatton v. Quad Realty Corp., 473 N.Y.S.2d 827, 829 (App. Div. 1984).

CONCLUSION:

As I have stated on numerous occasions,[7] I strongly support a statutory definition of insider trading. I believe these changes would strengthen the proposed legislation and would increase investor confidence in our capital market system.

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7. See Tidwell, "Here's a Tip--Know the Rules of Insider Trading," Summer 1987, Sloan Management Review, pp. 93-98.

JOINT RESPONSE OF
HARVEY L. PITT AND JOHN F. OLSON
TO QUESTIONS RE: S. 1380 POSED BY
SENATOR ALFONSE M. D'AMATO

Introductions

On June 22, 1987, Senator Alfonse M. D'Amato raised a number of questions concerning S. 1380, the Insider Trading Proscriptions Act of 1987 ("S. 1380" or the "Act"), following the testimony of Harvey L. Pitt and John F. Olson regarding this proposed legislation.* The following responses to Senator D'Amato's questions are respectfully submitted by Messrs. Pitt and Olson.**

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* A copy of Senator D'Amato's questions is attached hereto as Exhibit 1.

** The views expressed herein are solely those of Messrs. Pitt and Olson, and are not necessarily the views of their respective law firms, Fried, Frank, Harris, Shriver & Jacobson and Gibson, Dunn & Crutcher, or any other partner or client of either firm. Messrs. Pitt and Olson gratefully acknowledge the unstinting assistance of Karen L. Shapiro in preparing these responses.

Q.1. (a) What provisions of this legislation would cause corporations, law firms, brokerage houses, investment bankers and others involved in the securities business to make a greater effort to self-police their employees? How does this bill effect a firm's potential liability for the actions of its employees?

Firms involved in the securities industry must (and strive to) do all they can to instill in their principals and employees a high level of sensitivity and adherence to their obligations under the federal securities laws. Integral to that end is the implementation and maintenance of an appropriate supervisory system, as provided for by statutory and self-regulatory requirements applicable to registered securities market professionals. This affirmative obligation -- that securities brokers and dealers reasonably supervise their employees (and persons associated with the firm) -- and the derivative liability provisions of the Securities Exchange Act of 1934 ("Exchange Act")[1] are well-suited to motivate employers in the securities industry to self-police their organizations.

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[1] 15 U.S.C. §§ 78a, *et seq.* (1982).

The regulatory framework presently in place provides the government with ample authority to (i) discipline those firms that are regulated by the Securities and Exchange Commission (the "Commission" or "SEC"), such as broker-dealer and investment banking firms;[2] and (ii) seek remedies in federal court against firms not regulated by the Commission,[3] if inadequate supervision of employees leads to a violation of the federal securities laws. S. 1380 was not designed to, and does not, alter or diminish the effectiveness of that legal framework.

S. 1380 reinforces the impetus that firms engaged in the securities business already face to supervise their employees adequately. As noted above, the government possesses ample statutory authority to discipline firms whose failure to supervise their employees' conduct adequately is found to be a cause of a violation of the federal securities laws. The Act was drafted to address with specificity the two types of fact patterns that may be seen where an employee or member of a firm engaged in the securities industry violates the insider trading proscriptions of S. 1380:

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[2] See Section 15(b)(4)(E) of the Exchange Act, 15 U.S.C. § 78o(b)(4)(E) (1982) (authorizing administrative proceedings against registered brokers and dealers who aid, abet, counsel, command, induce or procure a violation of the federal securities laws or who fail reasonably to supervise their employees or associated persons).

[3] See Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a) (1982). See also Section 15(c)(4) of the Exchange Act, 15 U.S.C. § 78o(c)(4). Section 20(a) of the Exchange Act provides for joint and several liability of persons who control a person who violates the Exchange Act, unless the controlling person acted in good faith and did not directly or indirectly induce the violation. Section 15(c)(4) provides that the Commission may issue an administrative remedial order and findings against any person who violates, or causes the violation of, Sections 12, 13, 14 or 15(d) of the Exchange Act, 15 U.S.C. §§ 78l, 78m, 78n or 78o(d)(1982).

> (1) One department of a multi-function firm possesses material, nonpublic information concerning a security, and another department effects a trade in a security to which that information relates; and
>
> (2) A firm has implemented and maintained an adequate supervisory system to monitor compliance with the federal securities laws, but nevertheless winds up with a "bad apple" employee who deliberately sets out to circumvent the safeguards put into place by the firm.

In the first example, the firm will be derivatively liable for its employee's violation unless it sustains the burden of proving that: (i) the trade was not influenced by the information; and (ii) the person causing or effecting the trade did not know the information. Because this burden of proof is imposed on the firm, an additional affirmative incentive will motivate the industry to self-police its members. The statutory provision that reasonable "Chinese Wall" procedures to prevent and detect insider trading violations are relevant to this burden of proof provides further incentive for firms to implement and maintain such procedures.[4]

In the second category, if, for example, a registered broker-dealer firm employs an individual who trades on inside information through an off-shore account in a nondisclosure or "secrecy" jurisdiction, and the firm had no employment policy requiring that all personnel conduct their securities trading through in-house accounts, or that any trading through an outside account be promptly reported to the employer, then Section 15(b)(4)(E) of the Exchange Act, among other provisions, would provide the government with a meaningful mechanism for charging that the firm failed reasonably to supervise its employee.[5]

Additionally, any firm with a nexus to the securities industry may be subject to aiding and abetting liability in civil injunctive actions, if the standards for the imposition of such liability are satisfied.[6] The firm would not, however, be liable itself for an insider trading violation, unless it somehow participated in, or directly or indirectly induced the acts that constitute the insider trading violation.[7] Indeed, in such a case, the employer firm is more appropriately viewed as one of the *victims* of its employee's misdeeds. Deliberate fraud and evasion of a firm's reasonable prevention and detection mechanisms by an employee should not, in our view, form a basis for insider trading liability on the part of the employer.

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[4] The committee of lawyers who drafted S. 1380 declined to adopt as an element of the affirmative defense an absolute obligation on the part of firms to implement and maintain "Chinese Wall" procedures, as contained in the Commission's Rule 14e-3 and proposed statutory definition. In our view, if a firm has proved that the person effecting (or causing to be effected) the trade in question neither knew nor was influenced by the material, nonpublic information, the firm should not be liable for an insider trading violation. The liability of a firm that has failed to maintain reasonable procedures more appropriately should be addressed by the remedies discussed in the text.

[5] 15 U.S.C. § 78*o*(b)(4)(E) (1982); *see also* Section 15(c)(4) of the Exchange Act, 15 U.S.C. § 78*o*(c)(4) (1982), discussed *supra*, at n. 3.

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[6] The Supreme Court has left open the question whether aiding and abetting liability is applicable under the federal securities laws. *See*, *e.g.*, *Huddleston* v. *Herman & MacLean*, 459 U.S. 375, 380 n. 5 (1983); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 192 n. 7 (1976). Lower federal courts, however, have articulated, in various forms, the following three elements as predicates for the imposition of aiding and abetting liability in securities law cases:

> 1. A demonstration that a principal securities law violation has occurred;
> 2. The defendant had knowledge of the principal violator's unlawful conduct and of his own role in furthering that violation; and
> 3. The defendant knowingly and substantially assisted the principal violator in his fraudulent conduct.

See, *e.g.*, *Rolf* v. *Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 47-48 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *Woodward* v. *Metro Bank of Dallas*, 522 F.2d 84, 94-95 (5th Cir. 1975); *Securities & Exchange Comm'n* v. *Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975).

[7] *See* Proposed Section 16A(d) of the Act.

> **(b) If a firm failed to implement adequate safeguards and procedures to prevent insider trading violations of its employees, would it still be liable under the bill if the firm did not realize a profit or avoid a loss?**

Proposed Section 16A(d) of the Act provides that:

> No person shall be liable under this Section solely by reason of the fact that such person controls or employs a person who has violated this Section, if such controlling person or employer neither participated in, nor directly or indirectly induced the acts constituting the violation of this Section.[8]

This subsection is intended to clarify that the fact of employment or control of a person who commits an insider trading violation will not, by itself and without anything more, suffice to establish the derivative, or secondary, insider trading liability of the employer or controlling person for that violation. However, a firm that has failed to implement and maintain adequate supervisory and compliance procedures may be unable to avail itself of the protection provided by Proposed Section 16A(d) of the Act.

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[8] Proposed 15 U.S.C. § 78p A(d) (1987) (emphasis supplied).

Q.2 (a) In the first operative provision of the bill, the term "wrongful use" includes misappropriation. In simple terms state what "misappropriation" constitutes?

S. 1380 employs two terms that must be viewed together -- "misappropriation" and "conversion." In simple terms, these concepts encompass

- theft of information that belongs to another;

or

- conversion to one's own personal use of information received for a purpose not including securities trading for one's own personal enrichment or the enrichment of others.

The "misappropriation" theory was initially developed by the government as an alternative basis for sustaining the criminal conviction of a financial printer who was able to deduce the identity of targets of imminent takeovers from draft documents printed at the facility of his employer; he then used that information to purchase target company shares and profit from the increase in the price of those shares that resulted from the announcement of the bid.[9] The printer's conviction was overturned by the Supreme Court for lack of adequate presentation to the jury of the "misappropriation" theory. In his dissent, then Chief Justice Burger offered the opinion that

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[9] Chiarella v. United States, 445 U.S. 222, 224 (1980) ("Chiarella").

> a person who has misappropriated nonpublic information has an absolute duty to disclose that information or refrain from trading.[10]

Then Chief Justice Burger characterized the use of misappropriated information as the sort of "'undue' trading advantage" the antifraud provisions of the federal securities laws were designed to prevent.[11]

Since the Chiarella decision, the government has taken the "cue" provided in then Chief Justice Burger's dissent, and has successfully developed the definition and contours of the "misappropriation" theory in the lower courts by tailoring it to the specific facts of particular cases.[12]

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[10] Chiarella, 445 U.S. at 240 (Burger, C.J., dissenting).

[11] Id. (citing H.R. Conf. Rep. No. 229, 94th Cong., 1st Sess. 91, reprinted in 1975 U.S. Code Cong. & Admin. News 232).

[12] See, e.g., United States v. Winans, 612 F. Supp. 827 (S.D.N.Y. 1985), aff'd in part and rev'd in part sub nom. United States v. Carpenter, 791 F.2d 1024, 1029 (2d Cir. 1986) ("the misappropriation theory * * * proscribes the conversion by 'insiders' or others of material non-public information in connection with the purchase or sale of securities") (emphasis in original), cert. granted, 107 S. Ct. 666 (1986) ("Winans"); Securities & Exchange Comm'n v. Materia, 745 F.2d 197, 203 (2d Cir. 1984) ("Materia") ("one who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates Section 10(b) and Rule 10b-5"); United States v. Newman, 664 F.2d 12, 17 (2d Cir. 1981) ("Newman") (endorsing then Chief Justice Burger's dissenting opinion in Chiarella, supra n. 10), cert. denied, 464 U.S. 863 (1983); Securities & Exchange Comm'n v. Tome, 638 F. Supp. 596, 618 (S.D.N.Y. 1986) ("Tome") ("[t]he prerequisite for liability under the misappropriation theory is misuse of nonpublic information in breach of a fiduciary or similar duty

Footnote Continued

Thus, for example, federal district and circuit courts have found an actionable misappropriation of material, nonpublic information in cases where:

- a financial reporter converts to his own use information later to be published in a "market gossip column," widely recognized as exerting an influence on the market, in order to profit from the price movement in the market for the affected securities;[13]
- a financial printer divined the identity of targets of tender offers from draft documents printed at his place of employment, and purchased target company stock at pre-offer prices, to benefit from the increased price that followed announcement of the offer;[14]
- a securities trader knowingly received, used and tipped material, nonpublic information misappropriated by employees of an investment banking firm;[15] and
- a confidant of a corporate executive, whose advice was sought by that executive as to a possible hostile takeover bid, used material, nonpublic information solicited from the executive to execute carefully timed

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[12] Footnote Continued From Previous Page

of trust and confidence to *some* person or entity") (emphasis in original), *later proceeding*, 638 F. Supp. 629 (S.D.N.Y. 1986), *later proceeding* No. 81 C. 136 (MP) (S.D.N.Y. Apr. 3, 1987) .

[13] *Winans*.

[14] *Materia*.

[15] *Newman*.

> purchases in the target company's securities.[16]

The Supreme Court will rule on the validity and scope of the "misappropriation" theory by July of next year, having granted a writ of certiorari in the Winans case.[17] However, as we noted in our prior testimony, the decision rendered by the Court in Winans will, in all probability, be molded to the unique and narrow facts of that case; as in earlier cases, there may be significant differences among the justices, thus engendering continuing uncertainty as to what the law is.

Consequently, even an unqualified affirmation of the lower court conviction would likely provide narrow guidance applicable only to cases with similar facts. A reversal of the conviction, and rejection or severe limitation of the theory, could be devastating to the SEC's present insider trading enforcement program.[18] Thus, a statutory definition endorsing and adopting the "misappropriation" theory, rather than awaiting the likely problems that will result from a decision in Winans is, in our view, the preferable means of making law in this area.

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[16] Tome.

[17] See supra, n. 12.

[18] See Hearing Before the Subcomm. on Securities of the Senate Banking, Housing and Urban Affairs Comm., 100th Cong., 1st Sess. (June 17, 1987) (Joint Statement of Harvey L. Pitt and John F. Olson)

(b) Does this statute in effect codify the misappropriation theory which the SEC has employed successfully in the past?

The inclusion of the term "misappropriation" in the definition of the term "wrongful use" contained in proposed Section 16A(b)(1) of the Act is intended to codify and, to an extent, permit the courts, within statutorily defined parameters, to expand the "misappropriation" theory that has formed the basis of the Commission's successful insider trading prosecutions during the last several years.[19] The "misappropriation" theory, although only recently coming to the fore as an independent basis for insider trading liability, emerged from a long series of opinions in which courts and the Commission have observed that the possession of an improperly or unfairly obtained informational advantage imposes a duty of full and fair disclosure prior to effecting transactions in the securities that are the subject of that information.[20] One

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[19] See Joint Statement at 5 n. 5, 29.

[20] Securities & Exchange Comm'n v. Texas Gulf Sulphur Co., 401 F.2d 833, 848-49 (2d Cir. 1968) (insider who trades securities while in the possession of material, nonpublic information must disclose the information or refrain from trading, and may not avoid liability because of duty to preserve confidentiality of information); Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, 912 (1969) ("a corporate fiduciary, who is entrusted with potentially valuable information, may not appropriate that asset for his own use [in trading securities]"); Brophy v. Cities Service Co., 70 A.2d 5, 8 (Del. Ch. 1949) (employee who learned of company's stock repurchase plans may not use that nonpublic information for his

Footnote Continued

such decision focused specifically upon the means by which the informational advantage was attained, with the result that no disclosure obligation was found to arise from the skilled determinations of financial analysts or others who, through their own diligent analysis of publicly-available information, profited from well-timed investments in securities.[21]

Moreover, the Commission has, in the past, commenced enforcement actions in a number of cases involving facts very similar to those of *Chiarella*, all of which involved the improper conversion to personal use of material, nonpublic information obtained in the course of employment with a financial printer.[22] Although none of the cited cases, most

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[20] Footnote Continued From Previous Page

personal transactions in the company's stock); *In the Matter of Investors Management Co.*, 44 S.E.C. 633 (1971) ("*Investors Management*") (investment adviser who received nonpublic negative earnings information from issuer's prospective managing underwriter, and then sold out position in issuer's securities, violated the antifraud provisions of the federal securities laws).

[21] *Investors Management*, 44 S.E.C. at 641 n. 18 (information produced by analysis of generally known information does not give rise to duty to disclose).

[22] *Securities & Exchange Comm'n* v. *Manderano*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,357 (D.N.J. 1978); *Securities & Exchange Comm'n* v. *Primar Typographers, Inc.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,734 (S.D.N.Y. 1976); *Securities & Exchange Comm'n* v. *Ayoub*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,567 (S.D.N.Y. 1976); *Securities & Exchange Comm'n* v. *Sorg Printing Co., Inc.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,767 (S.D.N.Y. 1974).

of which were settled by consent, articulated the "misappropriation" theory in the form in which it has recently been employed, the conceptual seeds were sown. Thus, the "misappropriation" theory is the product of an evolutionary process of over 30 years of decisional principles.

(c) What are the prosecutorial limits of the misappropriation theory?

Since the "misappropriation" theory is a judicially-created construct, based upon arguments advanced by the government in connection with litigation of contested enforcement matters, currently there are no prosecutorial limitations on the application of the theory. A recent decision by the United States District Court for the Southern District of New York in a case involving an alleged co-conspirator of R. Foster Winans may impose an impediment, at least in the form of substantial delay, in any cases predicated on the "misappropriation" theory.

Among other things, the court ordered a delay in the criminal trial of one of Winans' alleged co-conspirators until the Supreme Court rules in United States v. Carpenter,[23] on the validity and scope of the "misappropriation" charge against the co-conspirator.[24] Thus, it is likely that that case -- the Clark opinion -- will lead to a motion for delay in every insider trading case relying on the "misappropriation" theory as a basis for liability.[25]

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[23] 791 F.2d 1024 (2d Cir.), cert. granted, 107 S. Ct. 666 (1986).

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[24] United States v. Clark, 87 Cr. 49 (JFK) (S.D.N.Y. June 30, 1987) ("Clark"). A copy of the opinion is attached hereto as Exhibit 3 (See hearing of August 7, 1987)

[25] We note, however, that counsel for Israel Grossman, a defendant in a recent criminal insider trading prosecution, did not seek any delay in his client's prosecution, and Mr. Grossman was just convicted. See United States v. Grossman, S. 87 Cr. 223 (RO) (S.D.N.Y. Aug. 18, 1987).

Q.3. (a) How will this definition interact with the antifraud provisions of the federal securities laws and the Insider Trading Sanctions Act?

The proposed legislation states, in the congressional findings[26/] and in an operative provision,[27/] that the standards embodied in the Act shall provide the exclusive statutory mechanism for prosecuting both government and private federal insider trading and tipping cases, in order to provide much-needed clarity in this area of the law. If no such exclusivity clause were provided in the Act, all the uncertainties and ambiguities that currently permeate the jurisprudence of insider trading -- together with the Due Process infirmities that inhere in a case-by-case articulation of what constitutes the crime of insider trading -- would remain in place, since any cases falling outside the scope of the proposed legislation would continue to be prosecuted under the antifraud provisions of the federal securities laws, with their attendant lack of precise guidelines.

Thus, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, would no longer be available as a statutory predicate for insider trading prosecutions; Rule 14e-3, promulgated under Section 14(e) of the Exchange

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[26/] *See* Proposed Section 16A(a)(4) of the Act.

[27/] *See* Proposed Section 16A(g) of the Act.

Act, presumably would be withdrawn as superfluous, upon enactment of the proposed legislation.

This legislation would not, however, diminish the vitality of Section 10(b) and Rule 10b-5 as vehicles for prosecuting other securities frauds, including frauds which may involve, among other elements, trading while in possession of material, nonpublic information, such as forms of market manipulation and scalping. Thus, as was originally intended, Section 10(b) would continue to provide a statutory "catch-all" prohibition against novel, unforeseen types of securities fraud.[28]

The proposed legislation provides a natural complement to the Insider Trading Sanctions Act of 1984 (the "Sanctions Act" or "ITSA"),[29] which would be preserved without change, by filling the definitional gap in that legislation.[30] At the time the Sanctions Act was passed, there was not yet a consensus among members of Congress and the

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[28] Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934) (testimony of Thomas G. Corcoran).

[29] Pub. L. No. 98-215, 97 Stat. 1473 (1984) (codified at 15 U.S.C. § 78(d)(2)(A) (Supp. II 1984)).

[30] We note, however, that the Commission in its proposed legislative definition of insider trading would effect certain technical amendments to the Sanctions Act, to conform its provisions to Section 16A. The Commission's proposals in that regard are sound, and we recommend their inclusion in any legislation that is ultimately enacted.

Commission that it was either necessary or possible adequately to define the offense of insider trading,[31] although clearly there was strong support for authorizing the SEC to seek treble civil fines in its prosecution of insider trading cases. Today, such a consensus exists.[32] By enacting a legislative definition of the underlying predicate offense, government (as well as private) prosecutions alleging insider trading will have a surer footing than that provided by the patchwork, piecemeal judicial definition that has evolved in the courts on a case-by-case basis.

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[31] *See*, *e.g.*, *The Insider Trading Sanctions Act of 1984: Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 2d Sess. 37 (1984) (testimony of John Fedders).

[32] *See* *Transcript of Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 100th Cong., 1st Sess. 22, 29-32 (Aug. 7, 1987)(Testimony of Acting Chairman Charles C. Cox); *Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 100th Cong., 1st Sess. (Aug. 7, 1987)(Statement of Harvey L. Pitt, Theodore A. Levine and John F. Olson) [hereinafter "*Pitt-Levine-Olson Statement*"]; *Transcript of Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 100th Cong., 1st Sess. 3, 5, 8-9 (June 17, 1987) (Statements of Sens. Donald W. Riegle and Alfonse M. D'Amato); *Joint Statement* at 2-4, 19-26. A copy of the *Pitt-Levine-Olson Statement* is attached hereto as Exhibit 4 (See hearing of August 7, 1987)

(b) Does the legislation provide for the recovery of damages by private parties for the illegal profits disgorged to the SEC?

The Act would expressly provide a private right of action for contemporaneous traders injured by an insider trading violation.[33] The damages clause provides that, in cases where a defendant found liable for damages in civil litigation has already disgorged his illegal profits gained (or losses avoided) in connection with a government prosecution arising from the same operative facts, the civil plaintiff(s) shall recover any damages awarded from the fund established for the disgorged amounts. Thus, the system established under ITSA, which provides for a maximum of disgorgement plus a treble civil fine, remains in place, unaltered by the proposed legislation.

The proposed legislation would, however, revise the standards for identifying the class of individuals in whom this private right of action reposes. As we observed in our earlier testimony, the proposed private right of action provision of the Act would effectively "overrule" the decision by the Court of Appeals in Moss v. Morgan Stanley ("Moss").[34] The Moss decision predicated the standing of private plaintiffs in insider trading cases on the Chiarella-Dirks[35] "breach of fiduciary duty" analysis, thereby depriving of a federal remedy those persons best able to articulate an insider trading injury -- that is, the persons who traded in the same market as the alleged insider trader but who did not possess his unfair informational advantage.[36]

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[33] See Proposed Section 16A(f) of the Act.

[34] 719 F.2d 5 (2d Cir. 1983), cert. denied, 465 U.S. 1025 (1984).

Thus, the Act advances two goals with the establishment of an express private remedy in insider trading cases: (i) The intended beneficiaries of the strictures of the Act will be assured a means by which to invoke that protection; and (ii) private, as well as governmental, enforcement of the insider trading proscriptions will vindicate the broad, remedial purposes of the Act.[37] As to other potential private claimants -- such as acquirers whose costs are allegedly increased by wrongful trading or tipping -- the Act takes no position, leaving those cases to be determined in the courts.

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[35] See Chiarella; Dirks v. Securities & Exchange Comm'n, 463 U.S. 646 (1983) ("Dirks").

[36] See Joint Statement at 38-39.

[37] Id. at 37; see also Pitt, H. & Shapiro, K., New Act May Help Clarify Law, N.Y.L.J., July 27, 1987. A copy of the Pitt-Shapiro article is attached hereto as Exhibit 5.

(See hearing of August 7, 1987)

Q.4. Does this bill change the basis for tippee liability that was enounced by the Court in Dirks? In Dirks the Court found that a tippee's trading is actionable under Rule 10b-5 "only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should have known that there has been a breach."

Proposed Section 16A(b) of S. 1380 would modify the standard for tippee liability set forth in the language of the Dirks opinion that is quoted in your question.[38/] In essence, the standards set forth in the Dirks opinion predicate tippee liability on the following elements:

1. an insider (or, perhaps, a "temporary" or "constructive" insider[39/]);
2. communicates material, nonpublic information to the tippee;
3. in breach of the insider's fiduciary duty to shareholders;

[38/] Dirks, 463 U.S. at 661. See Pitt and Ain, 'Dirks' Deals Blow to SEC Insider Trading Program, Legal Times, July 11, 1983, at 10, col. 1. A copy of the Pitt-Ain article is attached hereto as Exhibit 6. (See hearing of August 7, 1987)

[39/] The Court in Dirks observed that, in certain circumstances -- that is, when corporate insiders provide material, nonpublic information to corporate outsiders for an appropriate business purpose -- the outsiders may acquire the same fiduciary duty to the shareholders of the company as that of an insider, arising from the "special confidential relationship" with the Company into which they have entered. Id. at 656 n. 14. See also, infra, n. 45 and accompanying text.

4. in circumstances under which the tippee knows or should have known that there has been such a breach of duty by the insider; and

5. the tippee purchases or sells the affected securities.

This burdensome set of requirements has proven to impose an insurmountable obstacle in some government prosecutions, due to the onerous proof problems caused by the various elements of the standard.[40] Under this theory of liability, the government must plead and prove two separate violations, those of the tipper and the tippee, in order to sustain an action only against the tippee. Thus, if, in the course of an SEC investigation, an alleged tipper of inside information were to consent to an injunction, without admitting or denying the Commission's allegations, obviating the need for the SEC to prove an illegal tip, the government would nevertheless be required to prove the tipper's violation before being able to address the conduct of the tippee. In our view, this imposes an inappropriate burden on the government's already overtaxed resources.

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[40] See, e.g., United States v. Reed, 601 F. Supp. 685 (S.D.N.Y.), rev'd in part and aff'd in part, 773 F.2d 477 (2d Cir. 1985); Securities & Exchange Comm'n v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984) (corporate outsider who overhears insider discuss material, nonpublic information has no relationship with, and therefore owes no duty to, shareholders of insider's company).

Indeed, the Commission has refrained from bringing certain insider trading cases because of its concern that it would be unable to overcome the obstacle presented by the Dirks standards. See Transcript of Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 100th Cong., 1st Sess. 41 (Aug. 7, 1987) (Testimony of Gary G. Lynch).

The proposed legislation would reduce that burden. Proposed Section 16A(b)(1) of the Act, which contains the wrongful trading prohibition, does not set forth a separate standard of liability for tippees. Rather, the wrongful trading proscription focuses solely on the person who trades, and sets forth the following two elements of the offense:

1. direct or indirect trading while in possession of material, nonpublic information;[41]

2. which has been used or obtained wrongfully.[42]

Thus, the standard for tippee liability, and for other wrongful trading on "inside information" cases, properly focuses on the person effecting the trade, and how he obtained his information.

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[41] For persons other than natural persons, an affirmative defense to insider trading liability is available if the entity can prove that (i) the trade was not influenced by the material, nonpublic information; and (ii) the person effecting or causing the trade did not know the information. See Section 16A(b)(2); see also Pitt-Levine-Olson Statement at 16.

[42] As discussed supra, at pp. 7-13 and infra, at p. 27, the term "wrongful" has been expansively defined to embrace the Chiarella-Dirks "breach of duty" analyses and the "misappropriation" theory that is emerging from decisions at the district and circuit court levels, and is currently before the Supreme Court in the Winans case.

Q.5. Does this legislation embody the relatively broad concept of the term "insider" as articulated in *Dirks* by recognizing a class of constructive or temporary insiders?

The Act addresses its proscriptions *to* the manner in which material, nonpublic information is *obtained, communicated and used*.[43] Thus, an allegation of illegal insider trading or tipping under the Act could properly reach individuals and entities that are neither traditional insiders nor

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[43] The Commission's legislative proposal, by contrast, injects troublesome ambiguities into its wrongful trading proscriptions by going beyond the sharp focus on the obtaining, communication and use of information. For example, the Commission would prohibit "caus[ing] the purchase or sale of, any security while in possession of material, nonpublic information * * *," in addition to so purchasing or selling any security directly or indirectly. *See* SEC Proposed Section 16A(a). A copy of the SEC's proposal is attached hereto as Exhibit 7. This attempt to reach beyond the direct or indirect transaction could lead to unpredictable and unintended applications to a range of conduct that should not give rise to insider trading liability. *See* *Pitt-Levine-Olson Statement* at 9. (See hearing of August 7, 1987)

The Commission's proposal would also extend the definition of "wrongfulness" to reach information "obtained by *or as a result of*" certain enumerated types of conduct, *see* SEC Proposed Section 16A(a)(2), apparently eliminating any requirement of a culpable mental state from this aspect of its approach to wrongfulness. *See* *Pitt-Levine-Olson Statement* at 10.

Elsewhere in its proposals, the Commission qualifies its prohibitions by (i) enumerating the kinds of people with whom a relationship may give rise to a duty, *see* SEC Proposed Section 16A(a)(2); and (ii) excepting from the reach of the proposal's trading and tipping prohibitions such expansive classes of persons, *see* SEC Proposed Sections 16A(d)(3)-(5), that the exceptions may consume the rule. *See* *Pitt-Levine-Olson Statement* at 12, 15.

"constructive" or "temporary" insiders, as those terms have been defined by the courts,[44] if the communication, use or obtaining of the material, nonpublic information was "wrongful."

The "constructive" or "temporary" insider theory has developed in the lower courts as a means of addressing trading by persons who are not traditional corporate insiders but who nevertheless acquire material, nonpublic corporate information for a proper business purpose, and then improperly use that information for their personal benefit in connection with securities transactions. This theory was first applied, after the Supreme Court laid a foundation in *dicta*,[45] in the *Lund* case.[46]

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[44] *See*, *e.g.*, *Tome*, 638 F. Supp. at 616 (confidant of corporate officer who receives inside information concerning possible takeover plans for business purpose becomes a "temporary insider" of officer's company); *Securities & Exchange Comm'n* v. *Lund*, 570 F. Supp. 1397, 1402-03 (C.D. Cal. 1983) ("*Lund*") (individual given material, nonpublic information concerning possible joint venture while being solicited to participate therein becomes a "temporary insider" of company proposing the venture); *see also*, *Dirks*, 463 U.S. at 655 n. 14; *Securities & Exchange Comm'n* v. *Monarch Fund*, 608 F.2d 938, 942 (2d Cir. 1979); *cf.*, *Securities & Exchange Comm'n* v. *Musella*, 578 F. Supp. 425, 436-37 (S.D.N.Y. 1984).

[45] The Supreme Court, in the *Dirks* case, observed that outsiders who receive material, nonpublic information from insiders for business purposes may acquire the insider's fiduciary duty to shareholders by virtue of having entered into a "special confidential relationship" with the corporation. *Dirks*, 463 U.S. at 655 n. 14.

[46] *See* n. 44, *supra*.

Lund, an outsider, was approached by a longstanding friend (who was an officer of a public company) and was solicited to engage his firm in a joint venture with the corporate officer's company. Lund did not join his firm in the venture but, instead, purchased securities of a company identified by the corporate officer as a participant.[47] The court held that, while the insider had not breached any duty by communicating to Lund information about the joint venture, Lund, as a "temporary insider" of the participating company, did breach his fiduciary duty to that company's shareholders.[48] The court observed that

> [p]ersons who, although not traditional "insiders", nevertheless become fiduciaries of the corporation and the shareholders could be called "temporary insiders." They assume the duties of an insider temporarily, by virtue of a special relationship with the corporation.[49]

Thus, liability may be imposed for using for personal benefit material, nonpublic information received by virtue of that special relationship.[50]

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[47] Id. at 1399-1400.

[48] Id. at 1402-03.

[49] Id. at 1403 (footnote omitted).

[50] Id.

The "temporary insider" theory provided one of two bases of liability in the recent Tome decision.[51] The Tome case, which arose from the highly publicized hostile takeover of St. Joe Minerals Corp. ("St. Joe") by Joseph E. Seagram & Company ("Seagram"), involved a "crass abuse and betrayal of a personal and professional relationship of trust and confidence for personal gain."[52] Tome was an intimate social friend of Edgar Bronfman ("Bronfman"), Chairman and Chief Executive Officer of Seagram. While contemplating launching a hostile takeover bid for St. Joe, Bronfman sought Tome's opinion of, and advice on the transaction.

Tome, purportedly to enhance his ability to so advise Bronfman, solicited detailed information about the planned bid, but then used that material, nonpublic information to purchase stock and stock options in St. Joe for himself.[53] The court, in a strongly worded opinion, found Tome liable for insider trading under Section 10(b) and Rule 10b-5, both under the "misappropriation" theory and as a temporary insider of Seagram.[54] Relying on standards articulated in dicta in footnote 14 of the Dirks opinion, the court admonished that material, nonpublic information that is communicated in confidence to an outsider for business purposes may not be converted to personal use.[55]

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[51] See n. 12, supra.

[52] Id. at 599.

[53] Id. at 604-11.

[54] Id. at 620-22.

Proposed Section 16A(b)(1) of the Act sets forth an expansive definition of the term "wrongful," to embody the "temporary insider" theory discussed above, the "breach of duty" theory, set forth by the Supreme Court in Chiarella and Dirks,[56] and the "misappropriation" theory that has been developed in the lower courts,[57] and which is discussed more fully in the response to Question 2, *supra*.

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[55] *Id.* at 621.

[56] *See* *Dirks*, 463 U.S. at 655-65; *Chiarella* 445 U.S. at 227-31.

[57] *See* *Chiarella*, 445 U.S. at 244 n. 4 (Burger, C.J., dissenting); *United States* v. *Winans*, 612 F. Supp. 838-840. (S.D.N.Y. 1985), *aff'd in part and rev'd in part sub nom.* *United States* v. *Carpenter*, 791 F.2d 1024, 1028-29 (2d Cir.), *cert. granted*, 107 S. Ct. 666 (1986); *Materia*, 745 F.2d at 203; *Newman*, 664 F.2d at 18; *Tome*, 638 F. Supp. at 617-19; *United States* v. *Reed*, 601 F. Supp. 685, 700 (S.D.N.Y.), *rev'd*, 773 F.2d 477 (2d Cir. 1985).

Q.6. Some of my colleagues have urged us to increase the criminal sentences and criminal fines that can be imposed on inside traders. Do you think such increased penalties are appropriate for a crime that Congress has yet to define?

In our view, a more critical fairness inquiry arises one step earlier than in the issue your question poses: It is questionable whether, absent a specifically-defined legislative prohibition, any criminal prosecution of what is, in essence, a common-law crime, comports with traditional notions of fundamental fairness and due process.[58] Such an enforcement program raises a number of troublesome issues, including:

- whether an undefined offense with unknowable dimensions should properly be the subject of criminal prosecutions;
- whether, after declining to exercise its lawful rulemaking authority to define the contours of an offense, a government agency should be permitted instead to develop legal standards through *ad hoc*, punitive, enforcement proceedings; and
- whether a coherent, comprehensible set of standards is capable of development by means of piecemeal, patchwork "judicial legislation," as courts typically will only address the narrow issues before them in a particular controversy.

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[58] *See Joint Statement* at 4, 18, 22 & 26.

We are concerned that, despite encouragement from, among others, the Second Circuit Court of Appeals, which observed that:

> the permissible timing of insider transactions after disclosure of various sorts is one of the many areas of expertise for appropriate exercise of the SEC's rulemaking power, which we hope will be utilized in the future to provide some predictability of certainty for the business community * * *,[59]

the Commission nevertheless has declined to exercise its rulemaking authority to clarify its views as to precisely what constitutes appropriate and adequate dissemination of material corporate information prior to transactions in the affected securities.[60]

While the government's successfully-completed recent highly-publicized criminal insider trading prosecutions have centered almost exclusively around what can be characterized as "plain vanilla" cases,[61] not implicating questions concerning the location of the outer limits of the offense, other insider trading cases in the not so distant past have been less clear-cut -- findings of violations in two cases, one a criminal conviction, were reversed by the Supreme Court following the assertion that the statutory predicate for the prosecutions was vague or ambiguous;[62] a pending third case is widely believed to raise the same concerns.[63]

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[59] Securities & Exchange Comm'n v. Texas Gulf Sulphur Co., 401 F.2d 833, 854 n. 18 (2d Cir. 1968), cert. denied sub nom. Coates v. Securities & Exchange Comm'n, 394 U.S. 976 (1969).

[60] The Commission did at one point publicly announce formal rulemaking proceedings designed to result in the promulgation of explicit guidelines for insider trading actions under Rule 10b-5, but ultimately abandoned the project with no public announcement. See Exchange Act Release No. 10,316 (Aug. 1, 1973), 38 F.R. 21,541 (Aug. 9, 1973) ("SEC Inquiry Into Use of Undisclosed Material Information in Connection with Purchase or Sale of Securities). A copy of this Release is attached hereto as Exhibit 8.

Thus, in view of our concerns as to the prosecution of an undefined crime, we consider any legislation seeking to increase criminal fines and sentences for such an offense to be premature; any such legislation should await the clarification and legislative definition of the substantive offense of insider trading.

Conclusion

In our view, the process of formulating a concise, clear legislative definition of insider trading has been significantly advanced since its inception six months ago. As we work with the Commission and others toward the completion of a consensus bill, we remain confident that a legislative definition of insider trading and tipping can be achieved.

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[61] Understandably, we do not include in this characterization any pending or inchoate governmental prosecutions.

[62] Dirks; Chiarella.

[63] United States v. Carpenter, 791 F.2d 1024. See Transcript of Hearing Before the Subcomm. on Securities of the Senate Banking, Housing and Urban Affairs Comm., 100th Cong., 1st Sess. 64 (Aug. 7, 1987)(Testimony of Harvey L. Pitt).

Hypotheticals

1. A Corporation intends to make a tender offer for XYZ Company. It hires B as its investment banker, and asks him to buy 2.9% of XYZ's stock in his name and hold it until the tender offer is announced, which he does. B also calls C, however, his close friend, tells him about the tender offer, and authorizes C to buy as much XYZ stock as he can (up to 2.0%) and hold it until the tender offer is announced, which C does, at which time B and C will split the profits from the sale of XYZ, all unbeknownst to A Corporation. Is this excluded from prosecution under either S. 1380 or the Commission's draft revision?

S. 1380:

a. Investment banker B's arrangement with his client A, falls within the exception to § 16A(c)(2), since the two are acting in concert within the meaning of § 13(d)(3) of the Exchange Act. B has not wrongfully obtained the information about A's plans, nor has he used it for a purpose inconsistent with A's expectations.

b. If, unbeknownst to A, B entrusts the information to C in a similar arrangement, B would be liable under both subsections of § 16A(c). Under the general anti-tipping provision, (i) B has misappropriated or converted the information for his own personal use; (ii) B has also wrongfully communicated the information to C in breach of his fiduciary duty to A; (iii) C does in fact purchase the affected securities; (iv) B knows that the information would be used for the purchase; and (v) C's trade would give rise to his own liability, because he knew (or recklessly did not know) that B's communication of the information was wrongful. (This final point is not, however, an element of proof of B's liability for the tip).

SEC Proposal:

a. A's arrangement with B is lawful under the standard of the SEC's proposed § 16A(b): Since A could lawfully make the trade it has authorized to be effected by B, no breach has occurred. (B has neither used nor obtained the information wrongfully, and his trade does not give rise to liability).

b. Although the SEC's proposed codification of Rule 14e-3 would appear to prohibit B's arrangement with C, the exemption from the strictures of § 16A provided in subsection (d)(5) arguably removes this conduct from the reach of the prohibition: Since B lawfully could have made the trades carried out by C, with the authorization and on behalf of B, both B's communication and C's transaction appear to be exempt from liability.

2. A is a stock analyst. A interviews the CEO of XYZ Corp., who inadvertently tells A material, nonpublic, information in the course of the interview. After the interview, A calls his broker and buys XYZ stock. Has A violated S. 1380 or the Commission's suggested revisions? Could A tell his favorite institutional customer of this information?

S. 1380:

Under § 16A(b)(1), A would be liable only if he could be said to have converted the CEO's information to his personal use and trading of XYZ securities, when it was not intended to be used for that purpose. It is not clear that any conversion occurred. This is a question of fact.

A's communication of the information to his favorite customer would be wrongful, if the customer did in fact trade XYZ securities thereafter, and if such information was not provided to the analyst for the purpose of selective tipping. Again, this is a question of fact.

The lawfulness of the favored customer's trade is problematic; it would turn on whether the customer knew (or was reckless in not knowing) that A's communication was wrongful, if in fact the communication was wrongful.

SEC Proposal:

In order to hold A liable for trading XYZ securities following his conversation with the CEO, the SEC would have to prove that, under proposed § 16A(a)(2), A had a relationship with the CEO that gave rise to a duty to refrain from trading the securities. It is a question of fact whether the CEO entrusted the information to A to facilitate A's personal trading.

If A were to convey the CEO's information to a favored customer, he would be exempt from any liability under § 16A, based on the absolute protection accorded to analysts by § 16A(d)(4)(A), so long as the analyst (or his firm) regularly conveys information to customers in the ordinary course of business. A different result might obtain, depending on the circumstance under which A received the information, if a particular analyst, who had no clients of his own and did not customarily have any contact with other clients of the firm, tipped the information to a person who later traded XYZ securities. Such a communication might not be in the ordinary course of business; if it were not, it would not qualify for the protection of proposed § 16A(d)(4)(A).

3. A and B are two broker/dealers. They agree that it would be beneficial, in the ordinary course of their business, to

exchange material nonpublic information concerning corporate transactions of their clients for retransmission to their best customers. Would any of those communications be unlawful under S. 1380 or the SEC's proposed revisions?

S. 1380:

This arrangement would violate the anti-tipping provisions of § 16A(c)(1) at both levels, as both types of communications would be in breach of the firm's fiduciary duties to their clients and, thus wrongful, as defined in the statute. The offense of wrongful communication would be completed as soon as the intended (and, therefore, foreseeable) trade by the recipient took place.

SEC Proposal:

Although the Commission's anti-tipping proposal would reach this conduct, the exception provided in proposed § 16A(d)(4)(A) might preclude liability under the statutes for communications, in the ordinary course of business, by persons engaged in the business of analyzing and disseminating corporate, financial and market information. As broker/dealers engage in such business, any firm sufficiently brazen to establish such a tipping scheme as a part of its ordinary course of business might be able to invoke the protections of the SEC's proposed § 16A(d)(4)(A).

4. A is an investment banker. B is his friend and he remarks to A one day that A looks very tired. A explains that the reason is that he has been working day and night to salvage XYZ Corporation's finances and prevent its bankruptcy, due to XYZ's as yet undisclosed disastrous financial condition. B sells XYZ stock short in anticipation of the public announcement of XYZ's problems. Has B violated S. 1380 or the Commission's proposed revisions?

S. 1380:

B has violated the wrongful trading prohibition of § 16A(b)(1). B's use of the information is likely a conversion of information that was entrusted to him for one purpose, but which he used for another. Thus, B's trading would both breach a duty and constitute conversion, which would be a satisfactory predicate for a finding of wrongful use under § 16A(b)(1).

SEC Proposal:

B has not wrongfully obtained from A the information about XYZ's financial straits, within the scope of proposed § 16A(a)(1), nor is it clear that he has breached a duty recognizable under § 16A(a)(2): Although B has a personal relationship with A, and A falls within one of the types of persons enumerated in the proposal, it is not clear that a friendship gives rise to a duty not to trade or to keep the information confidential.

5. A multi-service firm has an investment banking department and a proprietary trading desk. A reasonable "Chinese Wall" procedure to prevent the transmission of information between the two departments is in place and, in fact, does prevent information from crossing the Wall. The investment banking department acquires material, nonpublic information about XYZ Company. Assume the proprietary trading desk trades XYZ securities for the firm's portfolio, and that the trader neither knew nor was influenced by the information. Would the firm be liable if:

   a. The firm has no other preventive procedures beyond the Chinese Wall.

   b. The firm's only additional preventive procedure is a "watch list," to enable the firm's Compliance Department to monitor trading for evidence of "cracks" in the Wall.

   c. Assume, now, that the firm had no Chinese Wall or other procedure in place, but in fact the person making the investment decision did not know and was not influenced by the information.

a. S. 1380:

The firm would not be liable under Section 16A(b)(1) since the person effecting the trade neither knew nor was influenced by the information. The firm thus would be able to sustain its burden of proof to invoke the affirmative defense provided to entities under § 16A(b)(2).

SEC Proposal

The firm would not be liable under the Commission's proposal, since the trader did not know the information and the firm had adequate Chinese Wall procedures to ensure against this type of violation.

b. The firm would not be liable under either set of standards, according to the same analysis as applied to example 5a, above.

c. S. 1380:

The firm would not be liable under the statute because the person effecting the trade neither knew nor was influenced by the information, thus meeting the requirements of the affirmative defense provided in § 16A(b)(2).

SEC Proposal:

The firm would be liable under the Commission's formulation since, although the person making the trading decision neither knew nor was influenced by the information, the firm did not have in place reasonable procedures to ensure that violative investment decisions were not made.

6. W is married to H, who is the Chairman of XYZ, a public company. Q, a well-known corporate raider, has informed H that he wants to acquire XYZ, an idea that H and his Board find unacceptable. W, unhappy about the strain this situation has imposed on her marriage, tells her psychiatrist, P, about Q's designs on XYZ during her weekly appointment. The psychiatrist purchases XYZ stock and, following the announcement of Q's bid for XYZ, sells his shares at the increased market price that resulted from the announcement.

S. 1380:

P has breached § 16A(b)(1), the wrongful trading prohibition. P converted to his personal use information entrusted to him by W for the purpose of furthering her psychiatric treatment.

SEC Proposal

The physician-patient relationship has long been recognized as being of a privileged and confidential nature. W confided to P the information about Q's intention to launch a bid for XYZ in the context of that confidential relationship. P may have breached his confidential relationship with W, if a court finds that this relationship gave rise to a duty to refrain from trading. (There has been no breach of the duty to keep confidential the information conveyed in the context of the relationship, since P has not disclosed that information).

The SEC Proposal, however, requires a second level of analysis: it next must be shown that W is a person within one of the seven categories enumerated in § 16A(a)(2). In order to satisfy the requirements of this subsection, two very tenuous links must be established. If H is a securityholder of XYZ (§ 16A(a)(2)(A)) and a court is satisfied that, by virtue of P's confidential relationship with W, he has an indirect confidential relationship with H (§ 16A(a)(2)(G)), then the Commission can reach P's trading under its proposed statute. It is not clear, however, that a court will find an indirect confidential relationship existed, and might not impose liability on the basis of such an attenuated relationship.

7. H, is Chief Financial Officer of XYZ, a public company. After H has worked long hours for several weeks and has begun to shown signs of depression, his wife, W, finally persuades him to explain the reason. H tells her that XYZ has lost its biggest customer, and bankruptcy now is imminent and unavoidable. W sells short XYZ stock the next morning.

S. 1380:

W has breached § 16A(b)(1), the wrongful trading proscription. The material, nonpublic information concerning the possible bankruptcy of XYZ was entrusted to her in confidence. Under the same analyses as in example 6, above, W converted that information to her personal use, which constitutes a wrongful use of the information.

SEC Proposal:

W clearly has a personal relationship with H, that should be found to give rise to a duty to preserve the confidentiality of information conveyed within the confines of that relationship. It next must be determined whether H, the source of W's information, falls within one of the Commission's categories of persons as to whom a breach of such duty constitutes wrongful trading. As those categories are currently articulated, the only fact that would render W liable is that H is a securityholder of XYZ. If, however, H owns no securities issued by his employer, there is no actionable breach of duty by W under the Commission Proposal.

8. X, an employee of a law firm handling the arrangements for the liquidation of A Corporation, a major supplier of widgets, converts that information to his personal use and purchases securities of B, C and D Companies, his client's competitors, anticipating that their market shares will increase dramatically when A terminates business, to be followed by a commensurate increase in the market price of their stock.

S. 1380:

X's conduct clearly violates proposed § 16A(b)(1) of S. 1380. X's personal use of this material, nonpublic information could be found to constitute conversion and or misappropriation of information made available for one purpose, but converted to X's unintended personal use. The fact that X traded securities of issuers other than his firm's client does not relieve him of liability; S. 1380 extends its trading proscriptions to trading while in possession of information relating not only to the securities of an issuer in which the trading occurs, but also to trading in the securities of other issuers to which the information is materially relevant.

SEC Proposal:

Under the SEC's proposal, it is not clear whether X's conduct is actionable. First, the SEC would have to show that X's relationship either constituted theft of information (which is not clear from the facts of this hypothetical) within the meaning of proposed § 16A(a)(1), or that X's relationship with his law firm falls within one of the enumerated categories in proposed § 16A(a)(2)(A)-(E). This is by no means clear.

Moreover, even if it could be said that X's relationship somehow fell within one of the enumerated categories, the SEC would still have to show that such relationship gave rise to either a duty to maintain such information in confidence or to refrain from trading in the securities in which he actually traded. Since X did not disclose the information, he did not breach any duty to maintain the information in confidence. And, since X's trading did not occur in the security about whose issuer X had information, X may not have violated any duty to refrain from trading.

In any event, since the Commission's proposed prohibition would only apply to trading in securities while in possession of information relating to those securities, X probably could escape liability under the Commission Proposal.

9. A, an employee of a brokerage firm, off on a frolic of his own, effects violative "insider" trades through an account maintained at another firm. A does not report either the account or the trades to his employer. A does not report either the account or the trades to his employer. The firm has a procedure that clearly requires that employees not maintain any outside account. In a completely unrelated instance involving no allegation of a violation of the law, it comes out in the course of a trial against A's firm that a supervisory procedure implemented by the firm did not ensure against violations. Is A's firm liable for A's violative conduct under either S. 1380 or the Commission Proposal?

S. 1380:

Under S. 1380, A's brokerage firm would not be liable for A's misconduct. Since the firm's only relationship with A was an employment relationship, and since the firm neither profited from, nor participated in A's misconduct, no liability could be imposed upon the firm in view of the exemption set forth in proposed § 16A(d).

SEC Proposal:

Under the Commission's Proposal, the firm might be liable for A's misconduct. Since the existence of supevisory procedures that *ensure* against violations of the law is a *sine qua non* of the firm's ability to avoid liability, a judge could find that the firm's lack of procedures that *ensured* against *different* violations of the law might preclude the firm from relying on any of the exclusionary provisions of SEC proposed § 16A(c)(2).